Supreme Court, U.S.
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No.

In the Supreme Court of the United States

OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, under Sections 2036 and 2043 of the Internal Revenue Code, when (i) a remainder interest is transferred by an individual who retains a life estate in the property and (ii) the consideration received by the transferor, although equal to the hypothetical value of the remainder, is less than the full value of the property, then (iii) the full value of the property less the value of the consideration received for the transfer of the remainder is brought within the transferor's gross estate upon her death.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statutes and regulations involved	2
Statement	4
Reasons for granting the petition	11
Conclusion	24
Appendix A	1a
Appendix B	27a
Appendix C	40a
Appendix D	42a

TABLE OF AUTHORITIES

Cases:

Commissioner v. *Bristol*, 121 F.2d 129 (1st Cir. 1941) 14

Commissioner v. *Estate of Church*, 335 U.S. 632 (1949) 22

Estate of Frothingham v. *Commissioner*, 60 T.C. 211 (1973) 14-15

Estate of Gregory v. *Commissioner*, 39 T.C. 1012 (1963) 17

Goldstone v. *United States*, 325 U.S. 687 (1945) 22

Gradow v. *United States*:

11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990) 8, 12, 15, 16, 18 19, 20, 23

897 F.2d 516 (Fed. Cir. 1990) 8, 9, 11-12, 15, 16

Parker v. *United States*, 894 F. Supp. 445 (N.D. Ga. 1995) 10

Pittman v. *United States*, 878 F. Supp. 833 (E.D.N.C. 1994) 9-10

Cases—Continued: Page

United States v. *Allen*, 293 F.3d 916 (10th Cir. 1961) 8, 12, 17, 18
United States v. *Past*, 347 F.2d 7 (9th Cir. 1965) 8, 12, 16, 17

Statutes and regulations:

Internal Revenue Code (26 U.S.C.):
§ 811(c) (1940) 13-14
§ 2001(a) 12
§ 2001(c) 21
§ 2012(a) 21
§ 2033 ..... 12, 20
§ 2035 ..... 13, 20
§ 2035(b)(1) 13, 14
§ 2035-2038 12
§ 2036 ..... *passim*
§ 2036(a) ..... *passim*
§ 2036(a)(1) 6, 19
§ 2037 ..... 13, 14, 20
§ 2037(a) 13, 14
§ 2038 ..... 13, 14, 20
§ 2038(a) 2, 20, 21
§ 2038(a)(1) 14
§ 2043 ..... 6, 9, 23
§ 2043(a) 2, 6, 15
§ 2051 12
§ 2502(a)(1) 21
§ 2512(b) 14, 21
§ 2701 22
§ 2701(a)(1) 21
§ 2701(a)(2) 22
§ 2701(a)(3)(A) 21
Revenue Act of 1926, ch. 27, § 302(c), 44 Stat. 70 13-14
26 C.F.R.:
Section 20.2036-1(a) 3-4
Section 20.2031-7A(d)(6) 5

Miscellaneous: Page

2 A.J. Casner, *Estate Planning* (Supp. 1995) 10
C. Lowndes, *Consideration and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinguishment of Marital Rights, Family Annuities, the Widow's Election, and Reciprocal Trusts*, 35 Geo. Wash. L. Rev. 50 (1966) 10
Stock Included in Estate Despite FMV Sale of Remainder, 24 Tax'n for Law. 248 (1996) 11

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PETITION FOR A WRIT OF CERTIORARI

The Acting Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-26a) is reported at 101 F.3d 309. The opinion of the Tax Court (App., *infra*, 27a-39a) is reported at 105 T.C. 252.

JURISDICTION

The judgment of the court of appeals (App., *infra*, 42a-43a) was entered on November 26, 1996. On February 14, 1997, Justice Souter extended the time within which to file a petition for a writ of certiorari to

and including March 26, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

1. Section 2036(a) of the Internal Revenue Code, 26 U.S.C. 2036(a), provides:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

2. Section 2038(a) of the Internal Revenue Code, 26 U.S.C. 2038(a), provides in relevant part:

> The value of the gross estate shall include the value of all property—
>
> (1) To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his

> death to any change through the exercise of a power * * * by the decedent alone or by the decedent in conjunction with any other person * * * to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death.
>
> * * * * *

3. Section 2043(a) of the Internal Revenue Code, 26 U.S.C. 2043(a), provides:

> If any one of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

4. Section 20.2036-1(a) of the Treasury Regulations on Estate Tax, 26 C.F.R. 20.2036-1(a), provides in relevant part:

> A decedent's gross estate includes under section 2036 the value of any interest in property transferred by the decedent after March 3, 1931, whether in trust or otherwise, except to the extent that the transfer was for an adequate and full consideration in money or money's worth (see § 20.2043-1), if the decedent retained or reserved

(1) for his life, or (2) for any period not ascertainable without reference to his death (if the transfer was made after June 6, 1932), or (3) for any period which does not in fact end before his death:

(i) The use, possession, right to the income, or other enjoyment of the transferred property, or

(ii) The right, either alone or in conjunction with any other person or persons, to designate the person or persons who shall possess or enjoy the transferred property or its income (except that, if the transfer was made before June 7, 1932, the right to designate must be retained by or reserved to the decedent alone).

If the decedent retained or reserved an interest or right with respect to all of the property transferred by him, the amount to be included in his gross estate under section 2036 is the value of the entire property, less only the value of any outstanding income interest which is not subject to the decedent's interest or right and which is actually being enjoyed by another person at the time of the decedent's death. * * *

STATEMENT

1. In 1983, Rose D'Ambrosio and her son each owned one-half of all classes of the common and preferred stock of Vaparo, Inc. (App., *infra*, 28a). Over the following years, Mrs. D'Ambrosio made several gifts of stock. On September 1, 1987, she retained ownership of 470 shares of preferred stock of Vaparo with a

stipulated value of $2,350,000 (*id.* at 29a).[1] On that date, she transferred a "remainder" interest in her preferred stock to the company, thereby retaining a "life estate" that entitled her to receive the dividends (if any) paid during her life. As consideration for her transfer of the "remainder" interest in this preferred stock, the company agreed to pay Mrs. D'Ambrosio the sum of $296,039 each year for the rest of her life (*id.* at 29a-30a).

On the date of this transfer, Mrs. D'Ambrosio was 80 years old. Based upon her actuarial life expectancy, the remainder interest in the preferred stock that she transferred to Vaparo had a hypothetical fair market value of $1,324,014.[2] Under the same actuarial assumptions, the annual payment that the company agreed to make to Mrs. D'Ambrosio as consideration for the transfer of the remainder interest had a hypothetical fair market value of the same amount (App., *infra*, 29a & n.4). See note 2, *supra*.

Mrs. D'Ambrosio died less than three years after she entered into this transaction. Prior to her death, she had received only two of the annual payments

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[1] The preferred stock had a par value of $5000 per share and was entitled to a non-cumulative dividend of 8% per annum (App., *infra*, 28a).

[2] This "hypothetical" value of the remainder was calculated by multiplying the stipulated value of the 470 shares of Vaparo preferred stock by the factor provided in Treasury regulations for determining the value of a remainder interest in property when the person whose life measures the preceding estate is 80 years old on the valuation date. See Treas. Reg. § 20.2031-7A(d)(6). This yields only a "hypothetical" value because it does not attempt to take into account the actual health of Mrs. D'Ambrosio on the date that the annuity agreement was made.

that the company had agreed to make in exchange for the "remainder" interest in the stock. In exchange for stock with a stipulated value of $2,350,000, she thus received actual payments of only $592,078 (App., *infra*, 30a).

During this same period, Mrs. D'Ambrosio also received $23,500 in dividends from her retained "life estate" in the preferred stock (App., *infra*, 29a n.3). These dividends were far less than the full amount of the stated dividend rate for that stock.[3] Because the preferred dividend obligation was non-cumulative, the unpaid dividends lapsed and their value thus accrued, indirectly, to the benefit of the common stockholders of the family-controlled corporation.

2. The executor of Mrs. D'Ambrosio's estate did not include any part of the value of the preferred stock in her gross estate. The Commissioner determined that adjustments to the estate's calculation of tax were required by Sections 2036 and 2043 of the Internal Revenue Code: (i) under Section 2036, the value of the stock is to be included in her gross estate because she transferred the stock for less than its full value and retained "the right to the income from the property" for her life (26 U.S.C. 2036(a)(1)); but, (ii) under Section 2043, the estate is to deduct from the value of the property thus included in the gross estate "the value of the consideration" that she received for the transfer (26 U.S.C. 2043(a)). These adjustments to the estate's return increased the

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[3] The full dividend on the 470 shares of $5000 par value preferred stock at the 8% dividend rate (see note 1, *supra*) would have yielded dividends of $188,000 *each year*. The family-controlled corporation, however, paid a total of only $23,500 in dividends on the preferred stock during this entire three-year period (App., *infra*, 29a n.3).

gross estate by $1,025,986—the difference between the value of the stock ($2,350,000) and the value of the annuity received as consideration for the transfer ($1,324,014) (App., *infra*, 30a).[4]

3. The estate petitioned the Tax Court for review of the Commissioner's determination. The estate took the position that the preferred stock was not includible in the gross estate under Section 2036 of the Code because decedent made "a bona fide sale for an adequate and full consideration" (26 U.S.C. 2036(a)) by transferring a remainder interest in the stock for an annuity of equal value (App., *infra*, 32a; see note 4, *supra*). Relying upon a long and consistent line of authority, however, the Commissioner contended that a transfer of property is not "a bona fide sale for an adequate and full consideration" within the meaning of Section 2036(a) unless the consideration received by the transferor equals the entire value of the property from which the remainder interest was severed (App., *infra*, 32a).

The Tax Court upheld the Commissioner's determination (App., *infra*, 27a-39a). The court agreed with the decisions cited by the Commissioner that

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[4] The Commissioner had initially determined that the consideration received by Mrs. D'Ambrosio for the transfer was limited to the actual annual payments (totalling $592,078) that she received before her death. In the Tax Court, however, the Commissioner accepted the estate's contention that the consideration that Mrs. D'Ambrosio received was the annuity from the company—the *promise* of the company to make such payments each year until her death—rather than only the payments she in fact received before her death. App., *infra*, 30a. The value of the promise to make such payments each year, based upon her actuarial life expectancy on the date of that promise, was stipulated to be $1,324,014. App., *infra*, 29a-30a.

hold that the sufficiency of the consideration for purposes of the bona fide sale exception to Section 2036 must be tested against the value of the property that would have been included in the gross estate if the transfer had not occurred—and therefore must be tested against the value of the entire property to which the retained life estate attached, not merely against the hypothetical value of the remainder interest (App., *infra*, 33a-38a, citing, *e.g.*, *Gradow* v. *United States*, 897 F.2d 516 (Fed. Cir. 1990), aff'g 11 Cl. Ct. 808 (1987); *United States* v. *Past*, 347 F.2d 7 (9th Cir. 1965); *United States* v. *Allen*, 293 F.2d 916 (10th Cir. 1961)).

The court explained that this case involves a common "estate planning technique intended to remove the value of property from Decedent's gross estate" in an effort to avoid the federal estate tax (App., *infra*, 30a). By transferring the "remainder" to the family corporation, while retaining the life estate, the decedent retained control over such property during her life and relinquished such control—to the natural objects of her affection—only upon her death. The court concluded that the transfer in this case "was of a testamentary nature," for it was "made when she was 80 years old to a family-owned corporation in return for an annuity worth more than $1 million less than the stock itself" (*id.* at 39a). The court observed that "[d]ecedent's gross estate would be depleted if the value of the preferred stock, in which she retained a life interest, was excluded therefrom" (*id.* at 38a-39a).

The court explained that Section 2036 is designed for the very purpose of preventing depletion of the gross estate through such pre-testamentary dispositions of property over which the decedent retains

control during her life. Both the text and the object of Section 2036 thus require that the value of the stock in which Mrs. D'Ambrosio retained a life estate be included in her gross estate. The court further agreed with the Commissioner, however, that, under Section 2043 of the Code, the estate is entitled to deduct the value of the consideration that she received (the annuity) from the value of the stock thus included in the gross estate (App., *infra*, 36a-39a).

4. a. The court of appeals reversed (App., *infra*, 1a-26a). The court noted that the plain text of Section 2036(a) generally requires property transferred by a decedent who retains a life estate to be included in the gross estate, but that this provision does not apply when "adequate and full consideration" is received in a "bona fide sale" of the property transferred. 26 U.S.C. 2036(a). The court concluded that, for "adequate and full" consideration to be received under Section 2036(a), the decedent need only receive consideration equal in value to the "interest" that was transferred (the "remainder" in this case)—and need not receive consideration equal to the value of the property to which the life estate attached (App., *infra*, 11a).

The court of appeals declined to follow the decisions on which the Tax Court relied, stating that they were either "inapposite or unpersuasive" (App., *infra*, 5a). In particular, the court directly rejected the decision of the Federal Circuit in *Gradow* v. *United States*, *supra*, stating (App., *infra*, 11a):[5]

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[5] The court of appeals stated that "[s]everal courts have followed the holding in *Gradow*, but none of their opinions provides any cogent analysis that persuade[s] us it is sound" (App., *infra*, 18a, citing, *e.g.*, *Pittman* v. *United States*, 878 F. Supp.

> we cannot agree with the *Gradow* court's conclusions that "property" refers to the fee simple interest and that adequate consideration must be measured against that value.

Instead, the court held that the text of the statute requires the conclusion "that the gross estate shall include the value of the remainder *interest*, unless it was sold for adequate and fair consideration" (*ibid.*).

Because the remainder "interest" in the preferred stock was transferred for an annuity with an equal hypothetical value, the court held that the consideration for this transfer was "adequate and full" and that no part of the property was brought back within the estate under Section 2036 (App., *infra*, 19a). The court stated that this interpretation of the statute would not cause any reduction in the value of the estate because the consideration received for the remainder, "if properly invested, will still be available

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833, 835 (E.D.N.C. 1994)). The court further stated that "other courts have questioned the soundness of *Gradow*, but have either applied it reluctantly or decided the case on other grounds" (App., *infra*, 18a, citing, *e.g.*, *Parker* v. *United States*, 894 F. Supp. 445, 447 (N.D. Ga. 1995)).

The court noted that extensive legal commentary has been written concerning "[t]he holdings of *Gradow* and the earlier cases" and that, while some commentators support the interpretation of Section 2036 set forth in *Gradow* (App., *infra*, 18a & 19a n.3, citing, *e.g.*, C. Lowndes, *Consideraton and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinquishment of Marital Rights, Family Annuities, the Widow's Election, and Reciprocal Trusts*, 35 Geo. Wash. L. Rev. 50, 56 (1966)), others support the interpretation adopted by the court in this case (App., *infra*, 18a, citing, *e.g.*, 2 A. J. Casner, *Estate Planning* § 6.15.2, at 6-146-50, 6-158 (Supp. 1995)).

for inclusion in the gross estate when she dies" (*id.* at 15a).

b. In dissent, Judge Cowen stated that "[t]oday the majority holds that a tax-avoidance approach previously considered 'too good to be true' can, at least in limited circumstances, actually be true" (App., *infra*, 20a, quoting *Stock Included in Estate Despite FMV Sale of Remainder*, 24 Tax'n for Law. 248 (1996)). He explained that the majority's interpretation of Section 2036(a) "thwarts its very purpose, enabling taxpayers to avoid paying estate taxes on property while retaining the income benefits of ownership" (App., *infra*, 21a). In Judge Cowen's view, the court should have adhered to the previously uniform interpretation of Section 2036 that established the "commanding principle that a taxpayer who fails to convey all interests in an asset, continuing to derive some benefit from the asset until death, must include the entire asset in the taxpayer's estate" (*id.* at 22a).

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals creates a direct conflict among the circuits on a frequently litigated question of substantial importance in estate planning and estate taxation. In the absence of review by this Court, this conflict among the circuits will encourage estate planning practices that are designed to shield abuse and that will produce repetitive and wasteful litigation. Resolution of the important recurring question presented in this case is needed to avoid continuing uncertainty and to assure even-handed application of the revenue laws.

1. The decision of the Third Circuit in this case squarely conflicts with the decision of the Federal Circuit in *Gradow* v. *United States*, 897 F.2d 516

(1990), aff'g 11 Cl. Ct. 808 (1987). It also conflicts with the interpretation of the statute adopted and applied by the Ninth Circuit in *United States* v. *Past*, 347 F.2d 7 (1965), and by the Tenth Circuit in *United States* v. *Allen*, 293 F.2d 916 (1961). In holding that a decedent may avoid estate taxation on property in which she retained a life estate merely by selling the remainder interest during her life for consideration equal to the hypothetical value of that remainder, the Third Circuit has misinterpreted the language, and misunderstood the purpose, of Section 2036 of the Internal Revenue Code.

a. The federal estate tax is a graduated tax imposed on the decedent's taxable estate. 26 U.S.C. 2001(a). The taxable estate is the decedent's gross estate less the deductions authorized by the Code. 26 U.S.C. 2051. The principal component of the gross estate is "[t]he value of all property to the extent of the interest therein of the decedent at the time of his death." 26 U.S.C. 2033. Congress has long recognized, however, that the estate tax could easily be evaded if it did not *also* reach property that a decedent purports to transfer during his life while in fact retaining enjoyment and control of the property until his death. In provisions dating to the first enactment of the estate tax in 1916, Congress has therefore required property transferred in four specific types of *inter vivos* transactions to be included within the gross estate. 26 U.S.C. 2035-2038.

The most common of the *inter vivos* transfers addressed in these provisions is the transfer of property with a retained life estate. Such a transfer is clearly testamentary in character, for it postpones the transferee's enjoyment of the asset until the transferor's death. Because of the testamentary nature of such

transfers, Section 2036(a) of the Code brings within the decedent's gross estate (26 U.S.C. 2036(a))

> [t]he value of * * * all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life * * * the possession or enjoyment of, or the right to the income from, the property.

Related estate tax provisions similarly bring into the gross estate transfers of property made within three years of death (26 U.S.C. 2035), transfers of property taking effect at death (26 U.S.C. 2037), and transfers of property with respect to which the decedent retained a power of revocation (26 U.S.C. 2038). These provisions comprehensively "pull back" within the gross estate property that a decedent purported to transfer during his life while in fact retaining economic control.

Each of these provisions contains an exception for transfers in which the "interest" of the decedent in the property was sold in "a bona fide sale for an adequate and full consideration in money or money's worth."[6] 26 U.S.C. 2035(b)(1), 2036(a), 2037(a),

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[6] Until 1954, these separate provisions were contained in a single Section of the Code. Section 811(c) of the Internal Revenue Code of 1939, which was derived from Section 302(c) of the Revenue Act of 1926, ch. 27, 44 Stat. 70, as amended, provided (emphasis added):

> The value of the gross estate of the decedent shall be determined by including the value * * * of all property * * * —
>
> * * * * *

2038(a)(1). This "bona fide sale" exception is designed to relieve from estate taxation any transfer in which the decedent received consideration sufficient to prevent depletion of the estate.[7] See *Commissioner* v. *Bristol*, 121 F.2d 129, 134 (1st Cir. 1941); *Estate of*

(c) To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, or of which he has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; *except in case of a bona fide sale for an adequate and full consideration in money or money's worth.* Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, may by the decedent within two years prior to his death without such consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this subchapter.

When, in 1954, this provision was divided into the various separate provisions that now exist as Sections 2035-2038 of the current Code, the italicized language in the above quotation was repeated in each of the individual Sections. That language appears in parentheticals placed in the middle of three of the new Sections (Sections 2036, 2037 and 2038) and appears as a separate subsection establishing an "exception" from the general rule of inclusion in the fourth (Sections 2035(b)(1)). See 26 U.S.C. 2035(b)(1), 2036(a), 2037(a), 2038(a)(1).

[7] The federal gift tax similarly provides that a gift occurs when property is transferred "for less than an adequate and full consideration in money or money's worth." 26 U.S.C. 2512(b).

Frothingham v. *Commissioner*, 60 T.C. 211, 215-216 (1973) (citing cases). Property transferred subject to a retained life estate will not qualify for the bona fide sale exception "unless replaced by property of equal value that could be exposed to inclusion in the decedent's gross estate" (*id.* at 216). If such property is transferred for a consideration that is *less* than its full value, the value of the property is brought back within the gross estate reduced, however, by the value of "the consideration received" by the decedent for the transfer. 26 U.S.C. 2043(a).

b. In *Gradow* v. *United States*, 897 F.2d at 518-519, the Federal Circuit concluded that the amount of consideration needed to satisfy the bona fide sale exception of Section 2036 of the Code is measured by the value of the *entire* "interest" owned by the decedent in the property prior to the transfer, not merely by the value of the *remainder* interest that was transferred.[8] Adopting the "extensive analysis" of the Claims Court opinion in that case, the court concluded that the "the most natural reading" of the statute and "[f]undamental principles of grammar"

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[8] In *Gradow* v. *United States*, a widow elected under her husband's will to transfer her share of community property to a trust, from which she obtained a life income interest, in exchange for an identical life interest in her husband's share of the community property. The Federal Circuit concluded that the consideration received by the widow (a life estate in her husband's one-half share of the community property) was not "adequate and full" consideration for the property that she transferred with a retained life estate (her fee interest in half of the entire community property) within the meaning of Section 2036(a). Because the consideration she received was not "adequate and full," the transfer did not qualify for the bona fide sale exception under the statute. 897 F.2d at 518; 11 Cl. Ct. at 816.

require the conclusion that the bona fide sale exception applies to the value of the entire property owned by the decedent to which the retained life estate attached. 897 F.2d at 519; 11 Cl. Ct. at 813. The court further noted that a contrary interpretation of Section 2036 would defeat the statutory objective of bringing back within the estate "property which would otherwise have been included in her gross estate" but for an *inter vivos* transfer of that property "for less than adequate consideration" (11 Cl. Ct. at 813, 816). 897 F.2d at 518-519.

This same interpretation of Section 2036(a) was adopted by the Ninth Circuit in *United States* v. *Past*, 347 F.2d at 12. In that case, the court held that, to qualify for the bona fide sale exception of Section 2036(a), "[t]he value of what the decedent received" from an *inter vivos* transfer of property with a retained life estate "must be measured against the value of the proprety she transferred."[9] 347 F.2d at 12.

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[9] In *United States* v. *Past*, a divorce settlement had placed the community property of both spouses in a trust in which the wife acquired a life interest. The value of the wife's share of the property transferred to the trust was $243,989; her remainder interest in that property was worth $100,643; and the value of the life estate she acquired in the property that her husband conveyed to the trust was $143,346. 347 F.2d at 13-14. The court rejected her estate's argument that the transfer was excepted from Section 2036(a) of the Code as a bona fide sale for adequate and full consideration. The court explained that, under Section 2036(a), "[t]he value of what the decedent received under the trust must be measured against the value of the property she transferred to the trust" (347 F.2d at 12). Because the decedent's contribution to the trust ($243,989) exceeded the consideration that she received in exchange ($143,346), the court held that she did not receive

Because the value of the property tranferred in that case exceeded the value of the consideration received in exchange, the court held that Section 2036 brought the property back within the gross estate and that the "bona fide sale" exception did not apply. 347 F.2d at 13-14. Accord, *Estate of Gregory* v. *Commissioner*, 39 T.C. 1012, 1016-1017 (1963).

The Tenth Circuit reached this same conclusion in *United States* v. *Allen*, 293 F.2d at 918. In *Allen*, the court held that the bona fide sale exception applies only when the consideration received for the transfer equals the value of "the interest which would otherwise be included in the gross estate" rather than only the value of "the interest transferred" (293 F.2d at 917).[10] As Judge Breitenstein emphasized in his concurring opinion (*id.* at 918):

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adequate and full consideration within the meaning of the statute. 347 F.2d at 13-14.

[10] In *Allen*, the decedent had transferred property in trust, reserving the income for life with the remainder to her children. Shortly before her death, and in contemplation of death, she sold her life interest to one of her children for slightly more than its actuarial value, which was then about 15 percent of the trust corpus. Her executor contended that none of the trust property was includable in her estate. The court of appeals recognized that the decedent had owned only a life estate when she made the transfer, had received consideration at least equal to the value of that life estate and, as a practical matter, had little or no possibility of selling the life estate for a sum equal to the value of the corpus. 293 F.2d at 917. The court held, however, that her transfer of the property to the trust was not made for an adequate and full consideration within the meaning of the statute (293 F.2d at 918):

> It does not seem plausible * * * that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. * * * Giving the statute a

> The fact that full and adequate consideration was paid for the transfer of the retained life estate is immaterial. To remove the trust property from inclusion in decedent's estate there must be full and adequate consideration paid for the interest which would be taxed. That interest is not the right to income for life but the right to the property * * * from which the income is produced.

c. In this case, however, the Third Circuit disagreed with these prior decisions. Acknowledging that its interpretation of the statute conflicts directly with the decision of the Federal Circuit in *Gradow* (App., *infra*, 11a), the court held that, under Section 2036(a), property transferred with a retained life estate is *not* brought within the estate tax if, at the time of the transfer, the decedent received consideration equal to the value of the *remainder* interest.[11] The court offered two rationales for its reading of the statute, neither of which withstands scrutiny.

(i) The court emphasized the language in the statute that specifies that the value of the gross estate includes "*the value of* all property *to the extent*

> reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value.

[11] For the reasons described above (pages 16-17 & notes 9 & 10), the court of appeals erred in stating that the decisions of the Ninth Circuit in *Past* and the Tenth Circuit in *Allen* are "inapposite" (App., *infra*, 5a). As the court explained in *Gradow*, while the facts of *Past* and *Allen* differ from the facts involved here and in *Gradow*, "those courts' adoption of the formula advanced by [the government] is unaffected" by the factual differences in the cases. 11 Cl. Ct. at 811.

of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration * * *)" (App., *infra*, 11a, quoting 26 U.S.C. 2036(a) (emphasis added by court)). The court concluded (App., *infra*, 11a) that the italicized statutory text links the concept of "adequate and full consideration" to the "interest * * * of which the decedent has * * * made a transfer." Based on that asserted textual link, the court reasoned that the "adequate and full consideration" that is required to exclude the value of the property from the gross estate under Section 2036(a) need only equal the value of the "interest * * * transferred"—which the court concluded was the *remainder* interest in the property (App., *infra*, 11a (emphasis omitted)). Because, in this case, the value of the remainder "interest" and the value of the annuity received in exchange for the remainder were hypothetically the same (see page 5 & note 2, *supra*), the court concluded that "adequate and full" consideration had been received and that the property was therefore *not* brought back within the estate under Section 2036(a) (App., *infra*, 19a).

As other courts have explained in detail, however, the "natural reading" of the text and "fundamental principles of grammar" preclude acceptance of the interpretation adopted by the court of appeals in this case. *Gradow* v. *United States*, 11 Cl. Ct. at 813. The entire text of the statute needs to be considered. The statute brings into the estate "the value of all property to the extent of any interest therein of which the dedecedent has at any time made a transfer * * * under which he has retained for his life * * * the possession or enjoyment of, or the right to the income from, the property * * * ." 26 U.S.C. 2036(a)(1).

Because it is impossible to retain a life estate from a "remainder" (for the life estate and the remainder are separate estates that together comprise the "property"), the "property" that has been transferred, and that is to be valued under the statute, necessarily refers to the entire "interest therein" possessed by the decedent who made the transfer.[12] See, *e.g.*, *Gradow* v. *United States*, 11 Cl. Ct. at 813. It is the "property" with respect to which the decedent has "made a transfer * * * under which he has retained" a life estate that is brought within the gross estate if less than an "adequate and full consideration" was received for that property (26 U.S.C. 2036(a)).

This intendment of the statute becomes more clear when this same statutory phrasing is considered as it appears in closely related estate tax provisions (see note 6, *supra*). For example, Section 2038(a) brings into the gross estate the value of property that the decedent transferred to a revocable trust. 26 U.S.C. 2038(a). The text of Section 2038(a) follows precisely the format of Section 2036(a) in specifying that the gross estate includes the value of all property "[t]o the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration * * *)" if the decedent retained for his life the power to revoke the transfer. 26 U.S.C. 2038(a). If the interpretation adopted by the court in this case of the *identical* statutory language in Section 2036(a) were applied to that same phrase in

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[12] The phrase "to the extent of any interest therein" frequently appears in estate tax provisions, for a decedent does not always own a 100% interest in "property" to which the tax applies. See, *e.g.*, 26 U.S.C. 2033, 2035, 2036, 2037, 2038.

Section 2038(a), then property that has been transferred subject to a power of revocation would *never* be brought back within the estate under Section 2038(a). This is because (i) the value of the "interest" transferred to a person who holds property received in a revocable transfer is "zero" (because he can be compelled to return it) and (ii) the consideration for such a revocable transfer that would be "adequate and full" is, therefore, also "zero." Applying the interpretation of this *same* statutory language adopted by the court in this case, Section 2038(a) would thus simply be written out of the Code. The court of appeals plainly erred in interpreting the language of Section 2036(a) in a manner that would make meaningless an historically related statutory provision that employs the same language.[13]

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[13] As the court of appeals noted (App., *infra*, 14a n.2), Section 2701 of the Code indirectly, and prospectively, affects one aspect of the broad question addressed in this case. Under that gift tax provision, which was enacted in 1990, a transfer of stock in a closely-held corporation made to a family member, with a retained interest for the transferor, is generally treated as a gift of the entire value of the stock unless the retained interest entitles the transferor to only a "qualified payment" (26 U.S.C. 2701(a)(1), (3)(A)). The term "qualified payment" generally refers to a right to receive cumulative, preferred dividends at a fixed rate. 26 U.S.C. 2071(c)(3)(A). Non-cumulative preferred stock of the type the decedent transferred in this case does not yield a "qualifed payment" under the statute; the transfer of the preferred stock by the decedent in this case would (if made after 1990) therefore constitute a gift to the extent that the value of the stock exceeded the consideration the transferor received (26 U.S.C. 2512(b)). If a gift tax had been paid on that transfer, it would achieve the same resulting tax as if the estate tax were paid in this case. See 26 U.S.C. 2502(a)(1), incorporating 26 U.S.C. 2001(c); 26 U.S.C. 2012(a).

(ii) The court of appeals also erred in stating that its interpretation of the statute is "'most consistent' with its purposes" (App., *infra*, 13a). Section 2036 provides a prophylactic rule for inherently testamentary transactions. As this Court has explained, this statute "[l]ook[s] to substance and not merely to form" (*Commissioner* v. *Estate of Church*, 335 U.S. 632, 644 (1949)). The statute recognizes that a transfer of income-producing property with a retained life estate is inherently testamentary in nature, for "the most valuable property attribute of the [asset is its] income." *Id.* at 645. Because such transfers do not, in substance, "become 'complete'" until death, the prophylactic rule of the statute "sweeps into the gross estate all property the ultimate possession or enjoyment of which is held in suspense until the moment of the decedent's death * * * ." *Id.* at 645, 646, quoting *Goldstone* v. *United States*, 325 U.S. 687, 690 (1945). It is thus the entire value of the property that is "swe[pt] into the gross estate" by Section 2036 and its related provisions (see note 6, *supra*).

The statute requires the value of property transferred with a retained life estate to be included in the "gross estate" unless it has been replaced by consideration of an equal amount. When (as in the present case) a *lesser* consideration was received by the transferor, the value of *that* consideration is deducted

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The fact that Section 2701 may facilitate (and expedite) the tax consequence that Congress intended in the narrow area addressed by that statute does not alter the broad significance of the court's ruling in this case. Section 2701 applies only to transfers of corporate stock in closely held corporations to family members (26 U.S.C. 2701(a)(1), (2)). Most transfers of property with retained life estates obviously fall outside the scope of that provision.

from the value of the property brought back within the gross estate. 26 U.S.C. 2043. The gross estate is thereby reconstituted in the same amount by which the *inter vivos* transfer sought to deplete it.

As the court explained in *Gradow* v. *United States*, 11 Cl. Ct. at 815-816, Section 2036(a) brings within the estate *inter vivos* transfers that are testamentary in nature—because such transfers take effect, in substance, only upon the transferor's death:

> § 2036(a) is a reflection of Congress' judgment that transfers with retained life estates are generally testamentary transactions and should be treated as such for estate tax purposes. The fond hope that a surviving spouse would take pains to invest, compound, and preserve inviolate all life income from half of a trust, knowing that it would thereupon be taxed without his or her having received any lifetime benefit, is a slim basis for putting a different construction on § 2036(a) than the one heretofore consistently adopted.

2. The decision in this case creates a conflict among the circuits on a recurring question of substantial importance to the administration of the estate tax. As the Tax Court noted in this case, it is a common "estate planning technique" to test the proper reach of Section 2036 through the use of *inter vivos* transfers of property in which the transferor retains a life estate (App., *infra*, 8a). Professional estate tax advisors have joined the federal courts in expressing uncertainty and disagreement over the meaning of the statute. See note 5, *supra*; App., *infra*, 18a-19a & n.3. Because "techniques for attempting to reduce estate taxes are limited only by the imagination of estate planners, and * * * new devices appear

regularly" (App., *infra*, 13a), the question presented in this case is frequently litigated and, indeed, is presently pending in two other courts of appeals. *Wheeler* v. *United States*, No. 96-50144 (5th Cir.) (argued Sept. 5, 1996); *Estate of Magnin* v. *Commissioner*, No. 96-70578 (9th Cir.).

In the absence of a resolution of this conflict among the circuits, the tax consequences of transactions that involve this common estate planning technique will vary based solely upon geographical happenstance. Resolution by this Court of this recurring question is needed to avoid continuing uncertainty and to assure even-handed application of the revenue laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1997

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 95-7643

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE

[Argued June 4, 1996]
[Decided Nov. 26, 1996]

OPINION OF THE COURT

Before: COWEN, NYGAARD and LEWIS, *Circuit Judges.*

NYGAARD, *Circuit Judge.*

Vita D'Ambrosio, executrix of the estate of Rose D'Ambrosio, appeals from a judgment of the United States Tax Court upholding a statutory notice of deficiency filed against the estate by the Commissioner of Internal Revenue. The tax court held that, even though the decedent had sold her remainder interest in closely held stock for its fair market value, 26 U.S.C. § 2036(a)(1) brought its entire fee simple value back into her gross estate. We will

reverse and remand with the direction that the tax court enter judgment in favor of appellant.

I.

The facts in this case have been stipulated by the parties. Decedent owned, *inter alia*, one half of the preferred stock of Vaparo, Inc.; these 470 shares had a fair market value of $2,350,000. In 1987, at the age of 80, decedent transferred her remainder interest in her shares to Vaparo in exchange for an annuity which was to pay her $296,039 per year and retained her income interest in the shares. There is no evidence in the record to indicate that she made this transfer in contemplation of death or with testamentary motivation. According to the actuarial tables set forth in the Treasury Regulations, the annuity had a fair market value of $1,324,014. The parties stipulate that this was also the fair market value of the remainder interest.

Decedent died in 1990, after receiving only $592,078 in annuity payments and $23,500 in dividends. Her executrix did not include any interest in the Vaparo stock when she computed decedent's gross estate. The Commissioner disagreed, issuing a notice of deficiency in which she asserted that the gross estate included the full, fee simple value of the Vaparo shares at the date of death, still worth an estimated $2,350,000, less the amount of annuity payments decedent received during life.[1] The estate then petitioned the tax court for redetermination of the alleged tax deficiency.

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[1] The Commissioner now concedes that the estate must be credited for the fair market value of that annuity rather than the lifetime payments received under it.

The tax court, relying largely on *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990), and *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963), ruled in favor of the Commissioner. Eschewing any attempt to construe the language of either the Code or the applicable Treasury Regulations, the tax court reasoned that the transfer of the remainder interest in the Vaparo stock was an abusive tax avoidance scheme that should not be permitted:

> In the instant case, we conclude that Decedent's transfer of the remainder interest in her preferred stock does not fall within the bona fide sale exception of section 2036(a). Decedent's gross estate would be depleted if the value of the preferred stock, in which she had retained a life interest, was excluded therefrom. Decedent's transfer of the remainder interest was of a testamentary nature, made when she was 80 years old to a family-owned corporation in return for an annuity worth more than $1 million less than the stock itself. Given our conclusion that Decedent did not receive adequate and full consideration under section 2036(a) for her 470 shares of Vaparo preferred stock, we hold that her gross estate includes the date of death value of that stock, less the value of the annuity.

Estate of D'Ambrosio v. Commissioner, 105 T.C. 252, 260 (1995). The executrix now appeals; we have jurisdiction under 26 U.S.C. § 7482. Both parties agree that our standard of review for this issue of law is plenary.

II.

Our nation's tax laws have, for several generations, imposed a tax upon decedents' estates. Under 26 U.S.C. § 2033, a decedent's gross estate includes "[t]he value of all property to the extent of any interest therein of the decedent at the time of his death." In addition the Code contains, among other provisions, § 2036(a), which provides, in pertinent part:

> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from the property[.]

Section 2036(a) effectively discourages manipulative transfers of remainder interests which are really testamentary in character by "pulling back" the full, fee simple value of the transferred property into the gross estate, except when the transfer was "a bona fide sale for adequate and full consideration."

There is no dispute that Rose D'Ambrosio retained a life interest in the Vaparo stock and sold the remainder back to the company. The issue is whether the sale of a remainder interest for its fair market value constitutes "adequate and full consideration" within the meaning of § 2036(a). Appellant argues

that it does. The Commissioner takes the position that only consideration equal to the fee simple value of the property is sufficient. Appellant has the better argument.

A.

The tax court and the Commissioner rely principally on four cases, *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd for the reasons set forth by the claims court*, 897 F.2d 516 (Fed. Cir. 1990); *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). We find these cases either inapposite or unpersuasive; we will discuss them in chronological order.

In *Allen*, the decedent set up an irrevocable *inter vivos* trust in which she retained a partial life estate and gave the remainder (as well as the remaining portion of the income) to her children. Apparently realizing the tax liability she had created for her estate under the predecessor of § 2036, she later attempted to sell her retained life interest to her son for an amount slightly in excess of its fair market value. After she died, the estate took the position that, because decedent had divested herself of her retained life interest for fair market value, none of the trust property was includable in her gross estate. The Court of Appeals disagreed, holding that consideration is only "adequate" if it equals or exceeds the value of the interest that would otherwise be included in the gross estate absent the transfer. *See* 293 F.2d at 917. Although acknowledging that the decedent owned only a life estate, which she could not realistically hope to sell for its fee simple value, the

court nevertheless rejected the estate's argument, opining:

> It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value.

Id. at 918 (citations omitted).

Allen, however, is inapposite, as the Commissioner now concedes, because it involved the sale of a life estate after the remainder had already been disposed of by gift, a testamentary transaction with a palpable tax evasion motive. This case, in contrast, involves the sale of a remainder for its stipulated fair market value. Nevertheless, we agree with its rationale that consideration should be measured against the value that would have been drawn into the gross estate absent the transfer. As the tax court persuasively reasoned in a later case:

> [W]here the transferred property is replaced by other property of equal value received in exchange, there is no reason to impose an estate tax in respect of the transferred property, for it is reasonable to assume that the property acquired in exchange will find its way into the decedent's

> gross estate at his death unless consumed or otherwise disposed of in a nontestamentary transaction in much the same manner as would the transferred property itself had the transfer not taken place. . . .
>
> In short, unless replaced by property of equal value that could be *exposed to inclusion* in the decedent's gross estate, the property transferred in a testamentary transaction of the type described in the statute must be included in his gross estate.

Estate of Frothingham v. Commissioner, 60 T.C. 211, 215-16 (1973) (emphasis added).

Gregory presents a closer factual analogy to D'Ambrosio's situation. *Gregory* was a "widow's election" case involving the testamentary disposition of community property. Typically in such cases, the husband wishes to pass the remainder interest in all of the marital property to his children, while providing for the lifetime needs of his surviving spouse. In a community property state, however, half of the marital property belongs to the wife as a matter of law, so he cannot pass it by his own will. To circumvent this problem, the will is drafted to give the widow a choice: take her one-half share in fee simple, according to law, or trust over her half of the community property in exchange for a life estate in the whole. Put another way, she trades the remainder interest in her half of the community property in exchange for a life estate in her husband's half.

In *Gregory*, the widow exchanged property worth approximately $66,000 for a life estate with an actuarial value of only around $12,000; by the time she died eight years later, the property she gave up had

appreciated to approximately $102,000. The tax court compared the $102,000 outflow to the $12,000 consideration and concluded that the widow's election did not constitute a bona fide sale for an adequate and full consideration. 39 T.C. at 1015-16. It also stated that "the statute excepts only those bona fide sales where the consideration received was of a comparable value *which would be includable in the transferor's gross estate.*" *Id.* at 1016 (emphasis added).

We believe that the *Gregory* court erred in its analysis, although it reached the correct result on the particular facts of that case. There is no way to know *ex ante* what the value of an asset will be at the death of a testator; although the date of death can be estimated through the use of actuarial tables, the actual appreciation of the property is unknowable, as are the prevailing interest, inflation and tax rates. Consequently, there is no way to ever be certain in advance whether the consideration is adequate and thus no way to know what tax treatment a transfer will receive. This level of uncertainty all but destroys any economic incentive to ever sell a remainder interest; yet, Congress never said in § 2036 that *all* transfers of such interests will be taxed at their fee simple value or that those transfers are illegal. Instead, it clearly contemplated situations in which a sale of a remainder would not cause the full value of the property to fall into the gross estate. Without some express indication from Congress, we will not presume it intended to eliminate wholesale the transfers of remainder interests. Therefore, rather than evaluate the adequacy of the consideration at the time the decedent dies, we will compare the value of the remainder transferred to the value of the consideration received, measured as of the date of the

transfer. Here, we need not address that valuation issue, because it is stipulated that the fair market value of the stock was the same on the date of transfer as it was on the date of death.

In *Gregory*, however, the $12,000 the decedent received was grossly inadequate against the value of the property she transferred, regardless of the valuation date. The court was therefore correct that the transfer was not for adequate and full consideration. Because of that gross inadequacy, however, the holding of *Gregory* does not extend to the issue now before us: whether, when a remainder is sold for its stipulated fair market value, the consideration received is inadequate because it is less than the fee simple value of the property.

The *Past* case was factually somewhat different, in that it involved a divorce settlement, but the substance of the transaction was the same as in *Gregory*: the sale of a remainder in one-half of the marital property in exchange for a life estate in the whole. In that case, however, the court valued the property the divorcing spouse gave up at about $244,000 and the life estate she received at about $143,000; as a result, it held that the consideration was inadequate. 347 F.2d at 13-14. In making these valuations, however, the court took the fee simple value of the trust property and divided it in half. This was analytically incorrect, however, because the divorcing wife never gave up the life estate in her half of the marital property. She contributed only her remainder interest in that half, and that is the value that should have been used in the court's analysis. Alternatively, the *Past* court could have used the fee simple value of the wife's share, but it would then have needed to measure that against the value of the life estate in *both* halves of the property.

Had the court employed this latter methodology, it would have seen that the $287,000 value of the life estate exceeded the $244,000 she contributed and would have found adequate consideration. Instead, it compared "apples and oranges" and, we believe, reached the wrong result.

B.

The facts in *Gradow* were similar to those in *Gregory*; both are "widow's election" cases. That case is particularly significant, however, because the court focused on the statutory language of § 2036. The court began its analysis, however, with a discussion of *Gregory*, *Past* and *Allen*. While acknowledging that it was not bound by those three cases, the *Gradow* court found them persuasive, for two reasons: 1) "the most natural reading of § 2036(a) leads to the same result[;]" and 2) their holding is "most consistent with the purposes of § 2036(a)." 11 Cl. Ct. at 813. We will discuss these rationales in turn.

1.

We examine first the *Gradow* court's construction of the statute. It opined that

> there is no question that the term "property" in the phrase "The gross estate shall include ... all property ... of which the decedent has at any time made a transfer" means that part of the trust corpus attributable to plaintiff. If § 2036(a) applies, all of Betty's former community property is brought into her gross estate. Fundamental principles of grammar dictate that the parenthetical exception which then follows—"(except in case of a bona fide sale . . .)"—refers to a transfer of that

> same property, *i.e.* the one-half of the community property she placed into the trust.

Id. (ellipses in original). We disagree; although the *Gradow* court's rationale appears plausible, we note that the court, in quoting the statute, left out significant portions of its language. Below is the text of § 2036, with the omitted words emphasized:

> The *value of the gross* estate shall include *the value of* all property *to the extent of any interest therein of* which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life * * * (1) the possession or enjoyment of, or the right to the income from, the property * * *

After parsing this language, we cannot agree with the *Gradow* court's conclusions that "property" refers to the fee simple interest and that adequate consideration must be measured against that value. Rather, we believe that the clear import of the phrase "to the extent of any interest therein" is that the gross estate shall include the value of the remainder *interest*, unless it was sold for adequate and fair consideration.

In addition to § 2036, Treas. Reg. § 20.2036-1 also addresses this issue. It provides, in pertinent part (emphases added):

> (a) In general. A decedent's gross estate includes under section 2036 the value of any *interest* in property *transferred* by the decedent . . . except to the extent that the transfer was for an adequate and full consideration in money or

> money's worth if the decedent retained or reserved (1) for his life . . .
>
> (i) The use, possession, right to the income, or other enjoyment of the *transferred property*, ...

Appellant refers us to the emphasized words "interest" and "transferred" in § 20.2036-1(a) and argues that "adequate and full consideration" must be measured against the interest transferred. The Commissioner, on the other hand, looks at the phrase "of the transferred property" in § 20.2036-1(a)(i) and concludes that, because one cannot retain any lifetime interest in a remainder, "property" must refer to the fee simple interest.

The regulation, unfortunately, is not exactingly drafted and does not parse "cleanly" under either party's interpretation. The Commissioner is of course correct that one cannot enjoy any sort of life interest in a remainder. On the other hand, appellant validly asks why, if the drafters of the regulation meant to include the full value of the property, they referred to the value of any "*interest* in property transferred." On balance, we believe that, if some words of the regulation must be construed as surplusage, it is more reasonable and faithful to the statutory text to render inoperative the word "transferred" in § 20.2036-1(a)(i) than it would be to strike "interest" in the first part of the section. We think it is likely that, although the choice of verbiage was less than precise, the drafters meant merely to refer to the "transferred" property so as to distinguish it from other property owned by the estate. It strains the judicial imagination, however, to conclude that the drafters used the term of art "interest in property" when they meant simply "property."

2.

The *Gradow* court also believed that its construction of § 2036 was "most consistent" with its purposes. 11 Cl. Ct. at 813. The tax court in this case, although recognizing that the issue has spawned considerable legal commentary and that scholars dispute its resolution, 105 T.C. at 254, was persuaded that decedent's sale of her remainder interest was testamentary in character and designed to avoid the payment of estate tax that otherwise would have been due. *Id.* at 260. It noted particularly that the transfer was made when decedent was eighty years old and that the value of the annuity she received was over $1 million less than the fee simple value of the stock she gave up. *Id.* Again, we disagree.

We too are cognizant that techniques for attempting to reduce estate taxes are limited only by the imagination of estate planners, and that new devices appear regularly. There is, to be sure, a role for the federal courts to play in properly limiting these techniques in accordance with the expressed intent of Congress. Under long-standing precedent, for example, we measure "consideration" in real economic terms, not as it might be evaluated under the common law of contract or property. *E.g., Commissioner v. Wemyss*, 324 U.S. 303, 65 S.Ct. 652 (1945) (promise of marriage insufficient consideration, for gift tax purposes, for tax-free transfer of property); *Merrill v. Fahs*, 324 U.S. 308, 65 S.Ct. 655, 89 L.Ed. 963 (1945) (same). Likewise, when the transfer of the remainder interest is essentially gratuitous and testamentary in character, we focus on substance rather than form and require that the full value of trust property be included in the gross estate, unless "the settlor

absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property." *See Commissioner v. Estate of Church*, 335 U.S. 632, 645, 69 S.Ct. 322, 329 (1949) (gratuitous transfer of remainder in trust for family members with possibility of reverter to estate); *accord Helvering v. Hallock*, 309 U.S. 106, 110, 60 S.Ct. 444, 447 (1940) (consolidation of three cases involving "dispositions of property by way of trust in which the settlement provides for return or reversion of the corpus to the donor upon a contingency terminable at his death").

On the other hand, it is not our role to police the techniques of estate planning by determining, based on our own policy views and perceptions, which transfers are abusive and which are not. That is properly the role of Congress, whose statutory enactments we are bound to interpret.[2] As stated *supra*, we think the statutory text better supports appellant's argument.

Even looking at this case in policy terms, however, it is difficult to fathom either the tax court's or the Commissioner's concerns about the "abusiveness" of this transaction. A hypothetical example will illustrate the point.

A fee simple interest is comprised of a life estate and a remainder. Returning to the widow's election cases, assume that the surviving spouse's share of the community property is valued at $2,000,000. Assuming that she decides not to accept the settlement and to keep that property, its whole value will be available

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[2] Indeed, subsequent to the transfer at issue here, Congress *did* enact legislation dealing with abusive transfers of remainder interests. *See* 26 U.S.C. §§ 2036(c) (repealed), 2701.

for inclusion in the gross estate at death, but only as long as the widow lives entirely on the income from the property. If she invades principal and sells some of the property in order to meet living expenses or purchase luxury items, then at least some of that value will not be included in the gross estate. Tax law, of course (with the exception of the gift tax), imposes no burdens on how a person spends her money during life.

Next, assume that same widow decides to sell her remainder and keep a life estate. As long as she sells the remainder for its fair market value, it makes no difference whether she receives cash, other property, or an annuity. All can be discounted to their respective present values and quantified. If she continues to support herself from the income from her life estate, the consideration she received in exchange for the remainder, if properly invested, will still be available for inclusion in the gross estate when she dies, as *Frothingham* and *Gregory* require. On the other hand, if her life estate is insufficient to meet her living expenses, the widow will have to invade the consideration she received in exchange for her remainder, but to no different an extent than she would under the previous hypothetical in which she retained the fee simple interest. In sum, there is simply no change in the date-of-death value of the final estate, regardless of which option she selects, at any given standard of living.

On the other hand, if the full, fee simple value of the property at the time of death is pulled back into the gross estate under § 2036(a), subject only to an offset for the consideration received, then the post-sale appreciation of the transferred asset will be taxed at death. Indeed, it will be double-taxed, because, all

things being equal, the consideration she received will also have appreciated and will be subject to tax on its increased value. In addition, it would appear virtually impossible, under the tax court's reasoning, ever to sell a remainder interest; if the adequacy of the consideration must be measured against the fee simple value of the property at the time of the transfer, the transferor will have to find an arms-length buyer willing to pay a fee simple price for a future interest. Unless a buyer is willing to speculate that the future value of the asset will skyrocket, few if any such sales will take place.

Another potential concern, expressed by the *Gradow* court, is that, under appellant's theory, "[a] young person could sell a remainder interest for a fraction of the property's [current, fee simple] worth, enjoy the property for life, and then pass it along without estate or gift tax consequences." 11 Cl. Ct. at 815. This reasoning is problematic, however, because it ignores the time value of money. Assume that a decedent sells his son a remainder interest in that much-debated and often-sold parcel of land called Blackacre, which is worth $1 million in fee simple, for its actuarial fair market value of $100,000 (an amount which implicitly includes the market value of Blackacre's expected appreciation). Decedent then invests the proceeds of the sale. If the rates of return for both assets are equal and decedent lives exactly as long as the actuarial tables predict, the consideration that decedent received for his remainder will equal the value of Blackacre on the date of his death. The equivalent value will, accordingly, still be included in the gross estate. Moreover, decedent's son will have only a $100,000 basis in Blackacre, because that is all he paid for it. He will then be subject to capital gains

taxes on its appreciated value if he decides to ever sell the property. Had Blackacre been passed by decedent's will and included in the gross estate, the son would have received a stepped-up basis at the time of his father's death or the alternate valuation date. We therefore have great difficulty understanding how this transaction could be abusive.

On this appeal, the Commissioner likewise argues for the *Gradow* rule on the rationale that "the retained life interest is in closely held stock whose dividend treatment is subject to the control of decedent and her family. In such circumstances, the amount of the dividend income that decedent was to receive from her life income interest in the Vaparo preferred stock was susceptible of manipulation[.]" Commissioner's Brief at 33. There is no evidence, however, that the Vaparo dividends *were* manipulated, and the Commissioner directs us to no authority that we should presume so. In addition, implicit in her argument is the proposition that the life estate was overvalued by the executor and the remainder correspondingly undervalued. Such a position, however, is directly contrary to the Commissioner's own stipulation regarding the values of those interests.

The Commissioner also asserts that the D'Ambrosio estate plan is "calculated to deplete decedent's estate in the event that she should not survive as long as her actuarially projected life expectancy." Commissioner's Brief at 34-35. We note first that the Commissioner does not argue that decedent transferred her remainder in contemplation of imminent death under such circumstances that the tables should not be applied. Leaving aside the untimely death of Rose D'Ambrosio, any given transferor of a remainder is equally likely to *outlive* the

tables, in which case she would collect more from her annuity, the gross estate would be correspondingly larger and the Commissioner would collect more tax revenue than if the remainder had never been transferred.

3.

Several courts have followed the holding in *Gradow*, but none of their opinions provides any cogent analysis that persuade us it is sound. *See Pittman* v. *United States*, 878 F.Supp. 833, 835 (E.D.N.C. 1994) (applying *Gradow* without analysis); *Wheeler v. United States*, No. SA-94-CA-964, 77 A.F.T.R.2d 96-1405, 96-1411, 1996 WL 266420, *4-*5 (W.D.Tex. Jan. 26, 1996) (similar). Two other courts have questioned the soundness of *Gradow*, but have either applied it reluctantly or decided the case on other grounds. *See Parker v. United States*, 894 F.Supp. 445, 447 (N.D. Ga.1995); *Estate of McLendon v. Commissioner*, Nos. 20324-90, 20325-90, T.C. Memo. 1993-459, 66 T.C.M. (CCH) 946, T.C.M. (P-H) ¶ 93,459, 1993 WL 391134, n. 24 and accompanying text (Tax Ct. Sept. 30, 1993), *rev'd on other grounds*, 77 A.F.T.R.2d 96-666, 77 F.3d 477 (5th Cir.1995).

The holdings of *Gradow* and the earlier cases such as *Gregory* have inspired considerable legal commentary, most of it critical. *See Jacques T. Schlenger et al., Cases Addressing Sale of Remainder Wrongly Decided*, 22 Estate Planning 305 (1995) (reproducing Professor Pennell's remarks criticizing *Pittman* as a "mindless" decision); 2 A. James Casner, *Estate Planning* § 6.15.2, at 6-146-50, 6-158 (Supp. 1995) (Professor Casner, criticizing *Gradow* court as lacking understanding of future interests, economics and time value of money); Jacques T. Schlenger *et al., Property*

Included in Estate Despite Sale of Remainder Interest, 23 Estate Planning 132 (1996) (criticizing reasoning of tax court in *D'Ambrosio*); Richard B. Stephens *et al.*, *Federal Estate and Gift Taxation* ¶ 4.08[1], at 4-138 (6th ed. 1991) (stating that payment of full consideration for remainder interest alone is sufficient under § 2036, but noting *Gregory*, *Past* and *Gradow* in a footnote); Peter M. Weinbaum, *Are Sales of Remainder Interests Still Available in Light of a New Decision?*, 14 Estate Planning 258 (1987) (criticizing *Gradow* for quoting and analyzing § 2036(a) out of context and for ignoring the value of the life estate in the wife's community property as consideration received in the transfer).[3] As discussed *supra*, we find this criticism to be well-taken.

III.

Because we conclude that the tax court erred as a matter of law when it determined that the consideration received by Rose D'Ambrosio for her remainder interest was not adequate and full, we will reverse and remand it to enter judgment in favor of the estate.

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[3] But *see* Joseph M. Dodge, *Tax Management* A-67, A-87 (1992); Stanley M. Johanson, *Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems*, 47 Tex. L. Rev. 1247 (1969); Charles L.B. Lowndes, *Consideration and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinquishment of Marital Rights, Family Annuities, the Widow's Election, and Reciprocal Trusts*, 35 Geo. Wash. L. Rev. 50 (1966). We have reviewed these sources and find them unpersuasive, largely for the reasons already discussed.

COWEN, *Circuit Judge, dissenting.*

Today the majority holds that a tax-avoidance approach previously considered "too good to be true"[4] can, at least in limited circumstances, actually be true. I respectfully dissent. The tax court's opinion is supported by well-established case law and the plain language of the Internal Revenue Code. It should be affirmed.

I.

The value of a gross estate includes the value of all property held by the decedent on the date of death. I.R.C. § 2033. Pursuant to section 2036(a), for federal estate tax purposes the gross estate also includes any property that is the subject of an inter vivos transfer and in which the taxpayer reserves an income interest in that property until death. The sole exception authorized by section 2036(a) is a "bona fide sale" in which the transferor receives "adequate and full consideration" in exchange for the transferred property. I.R.C. § 2036(a). The majority holds that under section 2036(a), "adequate and full consideration" must be provided merely for that portion of the taxpayer's property interest actually transferred, rather than for the full value of the property that is the basis for the ongoing income interest.

The majority excludes from the computation of "full and adequate consideration" the value of decedent's life interest in the transferred stock, on the grounds that D'Ambrosio retained that interest. The intended purpose of section 2036 is to prevent decedents from avoiding estate taxes by selling their

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[4] Stock Included in Estate Despite FMV Sale of Remainder, 24 *Tax'n for Law.* 248 (1996).

property to a third party but retaining the benefits of ownership during their lives. It includes in a decedent's gross estate the date-of-death value of

> all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life ... the possession or enjoyment of, or the right to the income from, the property.

I.R.C. § 2036(a). When a taxpayer makes a transfer with a retained life interest, the powerful arm of section 2036(a) pulls into the gross estate the full value of the transferred property, not merely the value of the remainder interest.

The majority accepts the view of the estate that the decedent "sold" only the remainder interest to Vaparo. This view of section 2036 sanctions tax evasion: It enables strategic segmentation of the property into multiple interests, with "adequate and full consideration" now required only for a specific transferred segment, rather than the indivisible whole. Such an interpretation of section 2036(a) thwarts its very purpose, enabling taxpayers to avoid paying estate taxes on property while retaining the income benefits of ownership. I would affirm the tax court's holding that "adequate and full consideration" assesses whether the consideration received is equal to the value of *the property that would have remained in the estate but for the transfer*, not whether it is commensurate with the value of the artfully separated portion of the property technically transferred.

II.

The well-reasoned case law construing section 2036(a) supports the ruling of the tax court. That law correctly tests the adequacy of the consideration received by a taxpayer against the amount that otherwise would be included in that taxpayer's gross estate. The majority distinguishes these cases by focusing on irrelevant distinctions, and overlooks the commanding principle that a taxpayer who fails to convey all interests in an asset, continuing to derive some benefit from the asset until death, must include the entire asset in the taxpayer's estate.

In *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir 1990), the surviving spouse transferred her full community property interest into a trust that held all of the couple's community property. Thereafter, the trust paid her all of the trust income during her life, and distributed the entire corpus of the trust to her son upon her death. Gradow's executor asserted that decedent's retained life interest was received in exchange for adequate and full consideration, so that none of the trust's assets were includable in her gross estate. The court disagreed, holding that the consideration paid by the decedent had to cover not only the remainder interest that was left to her son in the trust, but also her half of the underlying community property.

Other courts have acknowledged and followed this rule. *See United States v. Past*, 347 F.2d 7 (9th Cir. 1965) (consideration decedent received from trust had to be measured against the total value of the property she contributed to the trust, not only against the remainder interest in the property); *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961) (decedent who

received most of trust's income for life but before death sold her remainder interest to her children had to include the value of the trust assets corresponding to the percentage of the trust's income that she received); *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1016, 1963 WL 1488 (1963) (decedent who received a life estate in exchange for transferring property to a trust failed to qualify for exception because "[t]he statute excepts only those bona fide sales where the consideration received was of a comparable value which would be includable in the transferor's gross estate").

The paramount purpose of section 2036(a) is to prevent the depletion of estate assets when individuals retain the use and enjoyment of those assets until death. In *Commissioner v. Estate of Church*, 335 U.S. 632, 69 S.Ct. 322 (1949), the Supreme Court emphatically noted that

> an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property.

Id. at 645. D'Ambrosio clearly fails this requirement that all title, enjoyment, and possession of the transferred property be unequivocally halted. Commenting on the forerunner to section 2036(a) more than a half century ago, the Supreme Court stated that the law

> taxes not merely those interests which are deemed to pass at death according to refined technicalities of the law of property. It also taxes *inter vivos* transfers that are too much akin to

> testamentary dispositions not to be subjected to the same excise.

Helvering v. Hallock, 309 U.S. 106, 112, 60 S.Ct. 444, 448 (1940).

These cases clearly demonstrate that the concept of "adequate and full consideration," as used in sections 2035 through 2038, must be construed with reference to the special problems posed by trying to prevent testamentary-type transfers from evading estate tax. The bona fide sale analysis, which exempts property from inclusion in the gross estate pursuant to section 2036(a), cannot focus merely on the value of the limited property interest that is sold. It must also consider the property that would otherwise be included in the decedent's gross estate.

III.

The estate asserts that the tax court erred because it misunderstood or disregarded the "economic reality" of a sale of a remainder interest. To the contrary, it was precisely the tax court's awareness of the economic realities of a retained interest transaction that led it to follow well-established law. Executrix D'Ambrosio alleges that *Gradow* is inapposite and, in any event, was erroneously decided. She states that

> if the Decedent had retained and invested the dividends from the Vaparo Stock and from the annuity payments received during her life, the potential value of her gross estate as a result of the sale would be worth no less on the date of her death, than if she had never sold the remainder interest in the Vaparo Stock or if she had sold the

> entire interest in the Vaparo Stock and invested the proceeds therefrom for the rest of her life.

Appellant's brief at 11.

This view ignores the very reason for section 2036(a). Its purpose is precisely to prevent taxpayers from retaining the practical benefits of asset ownership during their lifetime while divesting themselves for estate tax purposes of a portion of that property. As the court in *Gradow* correctly explained:

> [The "economic reality" argument] flies squarely in the face of the Supreme Court's analysis as to the assumptions and purposes behind § 2036(a). [T]he Court has taught that while tax limitation is perfectly legitimate, § 2036(a) is a reflection of Congress' judgment that transfers with retained life estates are generally testamentary transactions and should be treated as such for estate tax purposes. The fond hope that a surviving spouse would take pains to invest, compound, and preserve inviolate all life income from half of a trust, knowing that it would thereupon be taxed without his having received any lifetime benefit, is a slim basis for putting a different construction on § 2036(a) than the one heretofore consistently adopted.

11 Cl. Ct. at 815-816.

Even if the annuity decedent received were not an attempt to deplete her property for estate tax purposes, courts have consistently held that section 2036(a) does not exempt transfers of property in which the taxpayer retains an income interest in his or her underlying assets. As the Tenth Circuit concluded in *Allen*:

> It does not seem plausible ... that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. . . . [I]n a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value.

293 F.2d at 918 (citations omitted).

IV.

I would affirm the decision of the tax court. I respectfully dissent.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

UNITED STATES TAX COURT

No. 6724-94

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Sept. 25, 1995]

OPINION

LARO, *Judge*:

The parties submitted this case to the Court without trial. Rule 122. The Estate of Rose D'Ambrosio, Deceased (hereinafter Decedent's estate), Vita D'Ambrosio, Executrix (hereinafter the executrix), petitioned the Court to redetermine respondent's determination of an $842,391 deficiency in the Federal estate tax of Decedent's estate. We must decide whether Decedent's gross estate for Federal estate tax purposes includes the value of 470 shares of preferred stock in which Decedent retained an income interest for her life, after she transferred the remainder interest in the stock for its fair market

value. We hold that Decedent's gross estate includes the date-of-death value of the stock, reduced by the value of the consideration she received in return for the remainder interest. Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the date of Decedent's death. Rule references are to the Tax Court Rules of Practice and Procedure.

BACKGROUND[1]

VAPARO, Inc. (Vaparo), is a closely held corporation organized under the laws of the State of New York. Vaparo was formed with one class of stock, one-half of which was owned by Decedent and one-half of which was owned by her son (Son). Vaparo was recapitalized on December 20, 1983, with three classes of stock. Each share of the first class, class A stock, was assigned a par value of $1. Each share of the second class, class B common stock, was valued at $0.[2] The third class, noncumulative convertible preferred stock, was assigned Vaparo's remaining value, giving each of the preferred shares a value of $5,000.

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[1] The stipulations and attached exhibits are incorporated herein by this reference. Decedent resided (and her will was probated) in New Jersey. The executrix resided in Brooklyn, New York, when she petitioned the Court.

[2] Under the recapitalization, all future appreciation of Vaparo was assigned to the class B common stock.

Immediately after Vaparo's recapitalization, its stock was owned as follows:

Shareholder	Shares of Class A Stock	Shares of Class B Common Stock	Shares of Preferred Stock
Son	50	5,000	500
Decedent	50	5,000	500

After the recapitalization, but before September 1, 1987, Decedent gave away all of her Vaparo stock, less 470 shares of her preferred stock. On September 1, 1987, when Decedent was 80 years old, she and Vaparo agreed that Vaparo would buy the remainder interest in these 470 shares. Under the agreement, Decedent sold Vaparo the remainder interest and retained the income interest in the shares for life.[3] The remainder interest in the shares was worth $1,324,014 at the time of sale, and the total value of the shares was $2,350,000.[4] Decedent received a private annuity worth $1,324,014, in consideration for the sale.

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[3] Decedent reported $23,500 in dividends from Vaparo on her 1987 Federal income tax return. For her 1988 through 1990 taxable years, Vaparo did not declare any dividends, and Decedent did not report any dividend income from Vaparo.

[4] The parties determined the value of the remainder interest in Decedent's preferred shares by multiplying the shares' fair market value by the appropriate remainder factor contained in the actuarial tables under sec. 20.2031, Estate Tax Regs. As stipulated by the parties: "The parties agree that this is a correct valuation of the remainder interest in the preferred stock." In view of this stipulation, we need not and do not consider the value of Decedent's preferred shares from a factual viewpoint, including the related question of whether Decedent's reserved life estate in a noncumulative preferred

Decedent died on May 25, 1990, after receiving annuity payments totaling $592,078. Decedent never sold, relinquished, or otherwise disposed of her income interest. Respondent determined, and reflected in her notice of deficiency, that $1,757,922 of stock was includable in Decedent's gross estate for Federal estate tax purposes. This amount equals the fair market value of 470 shares of Vaparo preferred stock ($2,350,000), less the annuity payments received by Decedent ($592,078). Respondent has since conceded that the maximum amount includable in Decedent's gross estate with respect to the preferred stock is its $2,350,000 value, less the $1,324,014 value of the annuity.

DISCUSSION

We are faced in this case with a Federal estate planning technique intended to remove the value of property from Decedent's gross estate. We must decide whether the test of adequate and full consideration under section 2036(a) takes into account the value of the entire property, i.e., the fee interest, or merely the value of the remainder interest as determined under the valuation tables prescribed by respondent. See e.g., sec. 20.2031-7, Estate Tax Regs. Numerous articles have been written on this issue, and the legal commentators debate its resolution.

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stock from which she received no dividends following the transaction at issue actually had value. Cf. *Berzon v. Commissioner*, 63 T.C. 601, 618-620 (1975), affd. 534 F.2d 528 (2d Cir. 1976). The actuarial tables are presumptively correct, and the record that the parties agreed to does not require the conclusion that Decedent's use of the tables is "unreaslistic and unreasonable" as in *Froh v. Commissioner*, 100 T.C. 1, 4 (1993), affd. without published opinion 46 F.3d 1141 (9th Cir. 1995).

Compare, e.g., Dodge, 50-5th T.M., Transfers with Retained Interests and Powers A-67 (1992) with 2 Casner, Estate Planning, sec. 6.15.2, at 149 n. 6 (5th ed. 1988 & Supp.1993).

Chapter 11 of the Internal Revenue Code imposes a Federal estate tax on the transfer of the taxable estate of a decedent who is a citizen or resident of the United States. Secs. 2001 and 2002. A decedent's gross estate is determined by reference to part III of chapter 11. Under this part, the value of the gross estate includes the value of all property to the extent of the decedent's interest therein on the date of death.[5] Sec. 2033.

A decedent's gross estate also includes property that is subject to section 2036(a), which applies when a decedent makes an inter vivos transfer of property without adequate and full consideration and reserves an income interest in the property for life. Section 2036(a) provides:

> General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life * * *
>
> (1) the possession or enjoyment of, or the right to the income from, the property * * *

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[5] This valuation is usually made at the time of death. The executor, however, may elect to value a decedent's property as of an alternate valuation date, e.g., 6 months after death. Sec. 2032.

Respondent argues that section 2036(a) requires that Decedent's gross estate include the value of 470 shares of Vaparo preferred stock, less the value of Decedent's annuity. Respondent argues that the "bona fide sale for adequate and full consideration" exception of section 2036(a) is inapplicable to the facts at hand because Decedent received consideration only for her remainder interest in the stock. According to the executrix, Decedent's gross estate does not include the value of any Vaparo preferred stock because, during her life, she sold the remainder interest in the stock for adequate and full consideration. The executrix argues that *Gradow v. United States*, 11 Cl. Ct. 808 (1987), affd. 897 F.2d 516 (Fed. Cir. 1990), the holding of which is contrary to her position, was wrongly decided by both the United States Claims Court and the Court of Appeals for the Federal Circuit.

According to the executrix' interpretation, section 2036(a) permits a taxpayer to remove the entire value of property from his or her gross estate by selling the remainder interest in the property for an amount equal to the value of the remainder interest. We do not agree. See *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963). We do not believe that the bona fide sale exception of section 2036(a) allows Decedent's estate to avoid the Federal estate tax on the value of the preferred stock in which Decedent retained an income interest until her death. We find the executrix' reliance on a private letter ruling and technical advice memoranda misplaced. Sec. 6110(b)(1), (j)(3) (private letter rulings and technical advice memoranda are not precedential); *Knapp v. Commissioner*, 90 T.C. 430, 438 n.5 (1988), affd. 867 F.2d 749 (2d Cir.

1989).[6] We also find that the executrix is mistaken in her reliance on the legislative history of section 2701, which was added to the Internal Revenue Code by section 11602(a) of the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, 104 Stat. 1388, 1388-491. As observed by the U.S. Supreme Court: "the views of one Congress as to the construction of a statute adopted many years before by another Congress have very little, if any, significance." *United States v. Southwestern Cable Co.*, 392 U.S. 157, 170 (1968) (quoting *Rainwater v. United States*, 356 U.S. 590, 593 (1958)).

In *Gradow v. United States*, *supra*, the U.S. Claims Court applied section 2036(a) to a case with facts similar to those of the case at hand. In the *Gradow* case, the surviving spouse could elect under her husband's will to: (1) Receive her one-half share of the couple's community property outright or (2) transfer her one-half interest to a trust that would hold all of the couple's community property, pay her all of the trust income during her life, and distribute the trust corpus to her son upon her death. She made the latter choice and, following her death, her executor included none of the trust assets in her gross estate. According to the executor, the estate included none of the trust's assets because the decedent's retained life interest was received in a transfer for adequate and full consideration under section 2036(a). The Commissioner disagreed. The Commissioner determined that the decedent's gross estate included the date-of-death value of the property which the decedent had contributed to the trust, less the value

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[6] Nor are we bound by the opinions of commentators on which the executrix relies.

of the consideration that she received in return. Agreeing with the Commissioner's position, the Claims Court held that the value of the decedent's transfer to the trust, namely her one-half share of the community property, was includable in her gross estate under section 2036(a), less the value of the consideration received by her in return for the transfer. According to the court, the consideration flowing from the taxpayer consisted of her half of the community property and did not consist only of the remainder interest that was left to her son under the trust. The Court of Appeals for the Federal Circuit affirmed, essentially for the reasons stated by the Claims Court.

In this Court, there is authority to a similar effect. In *Estate of Gregory v. Commissioner*, *supra*, as in the *Gradow* case, the decedent's husband died and under his will gave her a "widow's election" whether to take her separate share of the community property outright or instead permit her share to pass to a testamentary trust, whereby she would acquire a life interest in all of their community property. The decedent elected the life interest, with the result that her community property worth approximately $65,000 went into the trust with her husband's share. The actuarial value of her income interest in her husband's share was approximately $12,000. The Court held that the decedent's election was a transfer with a retained life estate that was outside of the bona fide sale exception of section 2036(a). The Court compared the decedent's life interest in her husband's share against the larger amount that she had placed in trust. The Court stated: "The statute excepts only those bona fide sales where the consideration received

was of a comparable value which would be includable in the transferor's gross estate." *Id.* at 1016.

Subsequently, in *United States v. Past*, 347 F.2d 7 (9th Cir. 1965), the Court of Appeals for the Ninth Circuit faced a comparable issue. In the *Past* case, pursuant to a divorce settlement, the community property of the decedent and her husband was transferred to a trust, in which the decedent received an income interest for life. Citing this Court's opinion in *Estate of Gregory v. Commissioner*, *supra*, the Court of Appeals rejected the argument of the decedent's estate that the decedent's transfer to the trust was excepted from section 2036(a) as a bona fide sale for adequate and full consideration. *United States v. Past*, *supra* at 12. Instead the court reasoned that the consideration received by the decedent from the trust had to be measured against the total value of the property that she contributed to the trust, and not only against the value of the remainder interest in the property. Given that the decedent transferred $243,989 in property to the trust in return for a life estate worth approximately $143,346, the Court of Appeals held that the decedent did not receive adequate and full consideration under section 2036(a). *Id.* at 13-14; accord *Parker v. United States*, 75 AFTR 2d 2509, 95-1 USTC par. 60199 (N.D. Ga. 1995); *Pittman v. United States*, 878 F.Supp. 833 (E.D.N.C. 1994).

The Court of Appeals for the Tenth Circuit used analogous reasoning in *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). In the *Allen* case, the decedent set up an inter vivos, irrevocable trust in which she retained 60 percent of the income for life, the other 40 percent passing to her two children who were also the beneficiaries of the remainder interest. Advised that her retention of the life estate would

cause the attributable part of corpus (valued at approximately $900,000) to be included in her gross estate for Federal estate tax purposes, the decedent sold her life interest to her son for $140,000, which was slightly greater than the $135,000 actuarial value of the interest. The Commissioner determined that 60 percent of the corpus, less the $140,000 purchase price, was includable in the decedent's gross estate. The executors disagreed. According to the executors, no part of the trust corpus was includable in the decedent's gross estate because the sale of the income interest was for adequate and full consideration. After the District Court agreed with the executors' position, the Court of Appeals for the Tenth Circuit reversed. According to the Court of Appeals:

> Our narrow question is thus whether the corpus of a reserved life estate is removed, for federal estate tax purposes, from a decedent's gross estate by a transfer at the value of such reserved life estate. In other words, must the consideration be paid for the interest transferred, or for the interest which would otherwise be included in the gross estate? [*Id.* at 917.]

In holding that the consideration must be paid for the interest that would otherwise be includable in the gross estate, the Court of Appeals first acknowledged the well-settled principle that a taxpayer may reduce his or her tax liability through any permissible means. The Court of Appeals then found, however, that the decedent's transaction was not a permissible means under this principle. The court stated:

> It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life es-

> tates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value. [*Id.* at 918; citations omitted.]

With this longstanding judicial precedent in mind, we are not persuaded by Decedent's estate's position in the instant case. We conclude that the congressional mandate embodied in section 2036(a) requires that the property in question be included in Decedent's gross estate. As observed by the Supreme Court in construing a predecessor of section 2036(a) in the context of transfers in trust:

> an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. * * * [*Commissioner v. Estate of Church*, 335 U.S. 632, 645 (1949).]

The Court has also stated that section 2036(a):

> taxes not merely those interests which are deemed to pass at death according to refined technicalities of the law of property. It also taxes *inter vivos* transfers that are too much akin to testamentary dispositions not to be subjected to

> the same excise. By bringing into the gross estate at his death that which the settlor gave contingently upon it, this Court fastened on the vital factor. It refused to subordinate the plain purposes of a modern fiscal measure to the wholly unrelated origins of the recondite learning of ancient property law. * * * [*Helvering v. Hallock*, 309 U.S. 106, 112 (1940).]

Accordingly, the amount of consideration which is necessary to remove property from a gross estate under the bona fide sale exception of section 2036(a) is not determined merely by reference to the common law definition of contractual consideration, *Merrill v. Fahs*, 324 U.S. 308 (1945); *Commissioner v. Wemyss*, 324 U.S. 303 (1945); *Estate of Gregory v. Commissioner*, 39 T.C. at 1016, or by the rules of the law of conveyance, *Helvering v. Hallock*, *supra* at 112; see *Estate of Hartshorne v. Commissioner*, 402 F.2d 592, 595 n. 4 (2d Cir. 1968), affg. 48 T.C. 882 (1967); *Estate of Frothingham v. Commissioner*, 60 T.C. 211, 215-216 (1973). Rather, the consideration received is compared to the value of the property that would have been included in the gross estate if the transfer had not occurred. The bona fide sale exception applies when an interest in property is transferred for sufficient consideration to prevent the depletion of the transferor's gross estate for Federal estate tax purposes. See *Estate of Gregory* v. *Commissioner*, *supra*.

In the instant case, we conclude that Decedent's transfer of the remainder interest in her preferred stock does not fall within the bona fide sale exception of section 2036(a). Decedent's gross estate would be depleted if the value of the preferred stock, in which

she had retained a life interest, was excluded therefrom. Decedent's transfer of the remainder interest was of a testamentary nature, made when she was 80 years old to a family-owned corporation in return for an annuity worth more than $1 million less than the stock itself. Given our conclusion that Decedent did not receive adequate and full consideration under section 2036(a) for her 470 shares of Vaparo preferred stock, we hold that her gross estate includes the date of death value of that stock, less the value of the annuity. Sec. 2043(a); sec. 20.2043-1(a), Estate Tax Regs. In so holding, we have considered all arguments made by the executrix and, to the extent not discussed above, have found them to be without merit.

To reflect concessions by the parties,

Decision will be entered under Rule 155.

APPENDIX C

UNITED STATES TAX COURT

No. 6724-94

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION

Pursuant to the opinion of the Court filed September 26, 1995, and incorporating herein the facts recited in respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is a deficiency in estate tax due from the petitioner in the amount of $333,138.82.

/s/ DAVID LARO
DAVID LARO
Judge

Entered: Nov. 8, 1995

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

It is further stipulated that the petitioner may claim a credit for State estate, inheritance, legacy or succession taxes, in an amount up to $36,631.81, and may present to the Internal Revenue Service proof of such payment within the statutory period.

STUART L. BROWN
Chief Counsel
Internal Revenue Service

/s/ LAURENCE E. FUNDLER
LAURENCE E. FUNDLER, ESQ.
Counsel for Petitioner
Tax Court No. FL0231
256 Columbia Turnpike
Florham Park, NJ 07932
(201) 239-3000

Date: Nov. 1, 1995

By: /s/ WILLIAM F. HALLEY
WILLIAM F. HALLEY
Assistant District Counsel
Tax Court No. HW0035
One Newark Center - Suite 1500
Newark, New Jersey 07102-5224
(201) 645-3048
Date: Nov. 1, 1995

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 95-7643

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX, APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE

ON APPEAL FROM THE UNITED STATES TAX COURT
(Tax Court Docket No. 94-06724)

JUDGMENT

Present: COWEN, NYGAARD, and LEWIS, *Circuit Judges*

This cause came on to be heard on the record from the United States District Tax Court and was argued by counsel on June 4, 1996.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court entered November 8, 1995, be, and the same is hereby reversed and the cause remanded to the Tax Court with direction to enter judgment in favor of the estate. Costs taxed against appellee. All

of the above in accordance with the opinion of this Court.

ATTEST:

/s/ P. DOUGLAS SISK
Clerk

Dated: November 26, 1996

Certified as a true copy and issued in lieu
of a formal mandate on January 17, 1997

Teste: P. Douglas Sisk
Clerk, U.S. Court of Appeals for the Third Circuit

Supreme Court, U.S.
FILED
APR 17 1997
OFFICE OF THE CLERK

No. 96-1486

In The

Supreme Court of the United States

October Term, 1996

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ESTATE OF ROSE D'AMBROSIO, Deceased,
VITA D'AMBROSIO, Executrix,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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TABLE OF CONTENTS

	Page
Statement of the Case	1
Reasons for Denying the Writ	6
I. The Third Circuit's Decision In This Case Is Correct.	7
II. Other Reasons Which Militate Against Granting Certiorari.	11
A. Congress has enacted new laws effectively eliminating the sale of a remainder interest transaction in estate planning.	11
B. The issue in the instant case is not frequently litigated.	13
C. The instant case was the first of its kind to reach a Federal circuit court, and accordingly, there is no conflict among the circuits.	14
Conclusion	16

TABLE OF CITATIONS

Cases Cited:

Burnet v. Harmel, 287 U.S. 103 (1932)	9
Estate of Gregory v. Commissioner, 39 T.C. 1012 (1963)	7, 13

Contents

Page

Gradow v. United States, 11 Cl. Ct. 808 (1987), *aff'd for the reasons set forth by the claims court*, 897 F.2d 516 (Fed. Cir. 1990) 7, 13, 14, 15

Pittman v. United States, 878 F. Supp. 833 (E.D.N.C. 1994) 7

Simpson v. United States, 252 U.S. 547 (1920) 4

United States v. Allen, 293 F.2d 916 (10th Cir. 1961) 7, 9, 13, 14, 15

United States v. Irvine and First Trust Nat. Assoc., 511 U.S. 224 (1994) 9

United States v. Past, 347 F.2d 7 (9th Cir. 1965) 7, 13, 14, 15

Statutes Cited:

26 U.S.C. § 2031(a) 2

26 U.S.C. § 2033 2

26 U.S.C. § 2036(a) ..... *passim*

26 U.S.C. § 2036(c) 11, 12

26 U.S.C. § 2701, *et seq.* 5, 11, 12, 13

26 U.S.C. § 2702 ..... 12, 13

Contents

	Page
26 U.S.C. § 2702(a)(2)(A)	12
26 U.S.C. § 2703	12
26 U.S.C. § 2704	12
OBRA, '87, P.L. 100-203, 12/22/87	11
OBRA, '90, P.L. 101-508, 11/5/90	11
New York Estate, Powers and Trust Laws:	
§ 6-3.1, *et seq.*	9
§ 6-4.1, *et seq.*	9
§ 6-5.1, *et seq.*	9
Other Authorities Cited:	
Treas. Reg. § 20.2036-1	8, 9, 10
Treas. Reg. § 25.2702-4(a)	12

STATEMENT OF THE CASE

This case involves the correct application of the parenthetical exception contained in 26 U.S.C. § 2036(a)[1] ("§ 2036(a)") where a transferor sells, not a fee interest in the subject property, but only the remainder interest in the property.

Section 2036(a) is designed to prevent an individual from avoiding the estate tax by transferring away his property gratuitously, or for a fraction of its fair market value, all the while retaining the use, enjoyment and benefit thereof, including

1. 26 U.S.C. § 2036(a) provides as follows:

> § 2036. Transfers with retained life estate.
>
> (a) General rule.
>
> The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death —
>
> (1) The possession or enjoyment of, or the right to the income from, the property; or
>
> (2) The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

All section references contained in this brief are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.

a life estate therein. The parenthetical exception contained in § 2036(a) excludes from its application the lifetime transfer of property, or lifetime transfer of an interest in property, for adequate and full consideration. Such transfers are excluded because the transferor has received in exchange for the transferred property, or transferred interest in property, the equivalent value in money or money's worth. Accordingly, the transferor has merely changed the type or nature of the property making up his potential gross estate[2], but has not reduced his potential gross estate as a result of the transfer.

Specifically, this case involves the application of the parenthetical exception contained in § 2036(a) to a properly structured sale of the remainder interest in shares of corporate stock, in exchange for consideration exactly equivalent in value (in money or money's worth) to the value of the remainder interest (the remainder interest being the only property interest transferred). Prior to the sale, the transferor owns the fee interest of the shares of stock. After the sale, the transferor owns the value of the retained life estate interest in the shares of stock and the value of the consideration received in exchange for the sale of the remainder interest. Together, the proceeds from the sale of the remainder interest plus the retained life estate interest, and the benefits flowing therefrom, equal the full value of the

---

2. The concept of "potential" gross estate is important to the issue in this case. The value of a gross estate is determined as of the date of death. 26 U.S.C. §§ 2031(a), 2033. Section 2036(a) is directed at lifetime transfers and is designed to prevent an individual from artificially depleting his potential gross estate. The focal point of a § 2036(a) analysis must be at the time of the subject transfer, and must consider whether the transferor's potential gross estate has been depleted (as of the transfer date) in contravention of § 2036(a). As will be discussed in more detail, *infra*, a properly structured sale of a remainder interest transaction has no depletive effect on the transferor's potential gross estate. Aptly stated by the Third Circuit, ". . . it is difficult to fathom either the tax court's or the Commissioner's concerns about the 'abusiveness' of this transaction." (Appendix of Petition ("Pet. App.") at 14a).

underlying subject stock. The transferor's potential gross estate after the sale has not been reduced; the transferor merely changed the nature of his property ownership (just the same as if the transferor sold the shares of stock outright and received cash in exchange; her potential gross estate after the sale has not changed as a result of the sale).

Had the Decedent survived until her life expectancy under the mortality tables and invested the annuity wisely, the amount included in the Decedent's gross estate from the sale of the remainder interest would have equalled the fair market value of her shares of stock at the time of the transaction. Furthermore, should the Decedent have lived past her life expectancy, said amount would be in excess of the shares' fair market value.

1. The relevant facts in this case, which were stipulated by the parties before the United States Tax Court, are as follows. On September 1, 1987, Rose D'Ambrosio ("Decedent") owned four hundred seventy (470) shares of preferred stock of Vaparo, Inc. ("Vaparo"), a closely held corporation organized under the laws of the State of New York. On September 1, 1987, the Decedent sold her remainder interest in her Vaparo preferred stock to Vaparo pursuant to a redemption agreement. In exchange for the sale, the Decedent received a private lifetime annuity, with appropriate annual payments in the amount of Two Hundred Ninety Six Thousand Thirty Nine ($296,039) Dollars. In addition to the lifetime annuity received from the sale, the Decedent retained the income interest of the Vaparo preferred stock for her life.

The fair market value of the four hundred seventy (470) shares of preferred stock of Vaparo, at the time of the sale of the Decedent's remainder interest therein, was Two Million Three Hundred Fifty Thousand ($2,350,000) Dollars. Using the Internal Revenue Service ("IRS") tables for valuing interests in

property, the remainder interest in the Decedent's Vaparo preferred stock was determined to have a fair market value of One Million Three Hundred Twenty Four Thousand Fourteen ($1,324,014) Dollars at the time of its sale. In addition, the Decedent's lifetime annuity which was received in exchange for the sale of the remainder interest was calculated to have a fair market value exactly equivalent to the remainder interest ($1,324,014).

The parties agreed by Stipulation before the Tax Court that the fair market value of the Decedent's four hundred seventy (470) shares of Vaparo preferred stock, the remainder interest therein, and the Decedent's lifetime annuity, were all correctly computed. In addition, the parties agreed by Stipulation before the Tax Court that the life expectancy of the Decedent, all valuation factors used in determining the fair market value of the property interests at issue and the annual payments under the Decedent's lifetime annuity, were all computed correctly using the IRS actuarial and valuation tables.[3]

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3. The IRS has prescribed and encouraged the use of extensive and detailed tables in order to determine the value of interests in property such as a remainder interest, a life estate, and the present value of an annuity agreement. These tables are an integral and necessary method of determining valuations for purposes of the administration of the Internal Revenue Code. This Court has long accepted this method of valuing property interests. *Simpson v. United States*, 252 U.S. 547 (1920). The value of the remainder interest of the Vaparo preferred stock and the present value of the lifetime annuity agreement, both of which were stipulated to be correctly computed, were determined by use of the very tables that the IRS has prescribed for just that purpose.

This Court should not be misguided by the mischaracterization of the use of the word "hypothetical" in the Petition of the Commissioner of Internal Revenue. (Petition "Pet." at 5 & n.2). The Commissioner heavily relies upon use of the IRS valuation tables in the administration of the Internal Revenue Code, and she has stipulated that the remainder interest of the Vaparo preferred stock was correctly valued and the annuity (based on the value of the remainder interest) was correctly computed, using her valuation tables. (Pet. App. at 2a).

2. The issue presented in this case is whether the sale of the Decedent's remainder interest in her Vaparo preferred stock in exchange for the lifetime annuity was for an adequate and full consideration so as to satisfy the parenthetical exception contained in § 2036(a)[4]. The resolution of this issue turns upon whether the adequate and full consideration test for purposes of the parenthetical exception of § 2036(a) is to be measured against the full value of the Vaparo preferred stock, or whether it is to be measured against the value of the remainder interest in the Vaparo preferred stock, as that was the only property interest transferred in the exchange.

3. The Decedent died on May 25, 1990, and her Estate timely filed a Federal estate tax return, Form 706. On February 15, 1994, the Commissioner of Internal Revenue ("Commissioner") mailed a notice of deficiency to the Estate of the Decedent ("Estate") alleging, *inter alia*, that the aggregate fair market value of the Vaparo preferred stock, less the total payments actually received under the annuity, is includible in the Decedent's gross estate[5]. The Estate filed a timely petition to the United States Tax Court regarding this issue.

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4. In 1990, Congress enacted the body of law found at 26 U.S.C. § 2701, *et seq.*, commonly known as "Chapter 14". Although the effect of the enactment of Chapter 14 to the sale of remainder interest transaction shall be discussed in more detail, *infra*, suffice it to say that Chapter 14 was designed to, and does address the estate and gift tax implications of the transaction at issue in the instant case. Chapter 14 does not apply to the Decedent's sale of her remainder interest in her Vaparo preferred stock because the sale was completed prior to the effective date of Chapter 14.

5. The Commissioner's notice of deficiency included the fair market value of the Vaparo preferred stock, less the amount of actual payments received under the lifetime annuity, in the Decedent's gross estate. However, the Commissioner stipulated in the Tax Court that for purposes of inclusion in the gross estate, the value of the Vaparo preferred stock should be reduced by the full value of the lifetime annuity as determined under the IRS valuation tables.

The Tax Court, blindly following a line of unpersuasive cases with inapposite facts to the instant case, determined that in order for the Decedent to have satisfied the adequate and full consideration test of § 2036(a), she would have had to receive consideration equal to the full value of the Vaparo preferred stock, even though she only sold the remainder interest (retaining the life income interest). In a well reasoned decision, the United States Court of Appeals for the Third Circuit reversed the decision of the Tax Court concluding that the Tax Court erred when it determined that the consideration received by the Decedent for her remainder interest was not adequate and full under § 2036(a). The Commissioner petitions for a writ of certiorari asking this Court to review the Third Circuit's decision.

REASONS FOR DENYING THE WRIT

The decision of the Third Circuit was correct and does not conflict with any decision of this Court or another court of appeals. This case does not present any legal question of general importance and the decision below is of no substantial practical significance. Review by this Court is not warranted.

The untenable position of the Commissioner is that even though the Decedent sold only the remainder interest in her Vaparo preferred stock, retaining a life income interest, § 2036(a) required that she receive consideration equal to the full value of the Vaparo preferred stock in order to satisfy the adequate and full consideration test of § 2036(a) This is a delusive interpretation of both the text of § 2036(a) and the intended application thereof by Congress. Furthermore, the Commissioner's position makes no practical sense. The Court should ask itself why a buyer would pay an amount equal to the full value of the Vaparo preferred stock, only to receive a portion or remainder interest therein?

I.

THE THIRD CIRCUIT'S DECISION IN THIS CASE IS CORRECT.

The Third Circuit, unlike the Tax Court, did not blindly follow the line of cases cited in support of the Commissioner's position on this issue[6]. Instead, the Third Circuit scrutinized the facts and application of law in each case, in order to determine their precedential value. With an eye towards a well reasoned decision, the Third Circuit correctly concluded that "these cases [are] either inapposite or unpersuasive . . ."[7] (Pet. App. at 5a).

The Third Circuit, thus turned its attention to the clear language of the relevant portions of § 2036(a). (Pet. App. at 11a). The statute reads, in pertinent part:

> The value of the gross estate shall include the value of all property *to the extent of any interest therein* of which the decedent has at any time made a transfer (except in case of a

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6. The line of cases that have been cited as support for the position of the Commissioner is as follows: *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd for the reasons set forth by the claims court*, 897 F.2d 516 (Fed. Cir. 1990); *United States v. Past*, 347 F.2d 7 (9th Cir. 1965); *Estate of Gregory v. Commissioner*, 39 T.C. 1012 (1963); and *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). Other, more recent cases have been proffered as support for the position of the Commissioner, none of which was decided by a Court of Appeals. *Cf. Pittman v. United States*, 878 F. Supp. 833 (E.D.N.C. 1994).

7. The Commissioner has attempted to show that there is a conflict among the circuits on the issue before this Court, referring to the cases of *Gradow*, *Past* and *Allen*. As will be discussed *infra*, this line of cases involves subject transactions that are significantly different than the properly structured sale of a remainder interest in the instant case, and accordingly they do not present a conflict among the circuits on the issue before this Court.

> bona fide sale for an adequate and full consideration in money or money's worth) . . . § 2036(a). (Emphasis added).

Correctly, and consistent with the unambiguous language of the statute, the Third Circuit held that "the clear import of the phrase 'to the extent of any interest therein' is that the gross estate shall include the value of the remainder interest, unless it was sold for adequate and fair consideration." (Pet. App. at 11a). The court found support for its interpretation in Treas. Reg. § 20.2036-1. (Pet. App. at 11a-12a).

The position of the Commissioner on this issue is motivated by a policy, other than that which can be elicited from the statute and its regulations. The Commissioner has attempted to create her own rules not found in the lucidity of the statute[8]. As the Third Circuit aptly expressed, "it is not our role to police the techniques of estate planning by determining, based upon our own policy views and perceptions, which transfers are abusive and which are not. That is properly the role of Congress . . ." (Pet. App. at 14a).

The Decedent was a resident of the State of New York where

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8. The Commissioner argues that the "natural reading" of the text of § 2036(a) precludes acceptance of the Third Circuit's decision. (Pet. at 19). In her discussion, though, the Commissioner clearly has not accepted the "natural reading". Instead, she has taken the express text of § 2036(a) and substituted words therein to fit her "desired reading". (Pet. at 19-20). In particular, the last sentence of the first paragraph on page 20 of her Petition reads that it is the property ". . . *with respect* to which the decedent . . ." has made a transfer. This highlighted language does not appear in § 2036(a), and has been substituted by the Commissioner in place of the statutory language, ". . . property *to the extent* of any interest therein of which the decedent has at any time made a transfer . . ." The alteration of statutory text is not in accord with the "natural reading" of a statute, and, of course, will result in a different interpretation than as written by Congress.

a remainder interest is a legal estate in property, alienable in its own right. New York Estate, Powers and Trust Law § 6-3.1, *et seq.*, § 6-4.1, *et seq.* and § 6-5.1, *et seq.* It is a longstanding principle that the tax consequences of a transaction depends upon the nature of the property interest created under state law. *United States v. Irvine and First Trust Nat. Assoc.*, 511 U.S. 224 (1994); *Burnet v. Harmel*, 287 U.S. 103, 110 (1932). That the Decedent's transfer was only to the extent of her remainder interest in her Vaparo preferred stock is uncontroverted (and, in fact, conceded to by the Commissioner in the Tax Court). (Pet. App. at 2a). Thus, the value of the lifetime annuity being exactly equivalent to the fair market value of the remainder interest, the Decedent received adequate and full consideration for the ". . . interest [in the property] of which [she] has at any time made a transfer . . ." § 2036(a). The Commissioner's position is wholly irreconcilable with the text of § 2036(a).

The language of § 2036(a) is clear and unambiguous that, by virtue of the parenthetical exception, it excludes from its application any *interest* in property that was sold for an adequate and full consideration. Section 2036(a) contains no language that supports the position that the adequate and full consideration test is measured against the full value of property where a transferor sells only an interest in that property. It is illogical and unrealistic, for purposes of the parenthetical exception, to presume that the drafters of § 2036(a) intended for a buyer to pay an amount equal to the full value of property, only to receive a portion or partial interest of that property. The court in *Allen* is in accord with this position in recognizing that the consideration for the sale of the life estate in that case was adequate and that it would have been virtually impossible to sell the life estate for an amount equal to the full value of the underlying property. 293 F.2d at 917. Treas. Reg. § 20.2036-1 supports this conclusion by providing that, "A decedent's gross estate includes under § 2036 the value of any *interest* in property

transferred by the decedent . . . except to the extent that the *transfer* was for an adequate and full consideration in money or money's worth . . ." *Id.* (Emphasis added).

The clear language of § 2036(a) and Treas. Reg. § 20.2036-1 support that the parenthetical exception removes from the application of § 2036(a) any transferred interest, including a remainder interest, so long as the transfer was for an adequate and full consideration. The focus of the parenthetical exception contained in § 2036(a) is the transfer and the transferred interest. The value of the retained interest should be of no consequence where the consideration for the transferred interest is adequate and full.

To read the statute the way the Commissioner suggests, would require the words "any interest therein" as contained in § 2036(a) to have no meaning.

Beyond satisfaction of the textual requirements of § 2036(a), the economic reality connected with a properly structured sale of a remainder interest transaction is not inconsistent with the purpose and design of the statute, *e.g.*, to prevent the artificial depletion of an estate. The Third Circuit, in recognizing this, found it ". . . difficult to fathom either the tax court's or the Commissioner's concerns about 'abusiveness' of this transaction." (Pet. App. at 14a).

In the instant case, the Decedent received the lifetime annuity in exchange for her remainder interest in her Vaparo preferred stock and retained the life income interest in the stock. After the sale, the value of the Decedent's potential gross estate remained exactly the same. And, as the Third Circuit recognized, the Decedent's untimely death two and one-half years after the sale is of no concern because the "transferor of a remainder is equally likely to *outlive* the tables, in which case she would

collect more from her annuity, the gross estate would be correspondingly larger and the Commissioner would collect more tax revenue than if the remainder had never been transferred." (Pet. App. at 17a-18a).

After the submission of briefs and oral arguments made by both parties to this dispute, the Third Circuit reached the correct decision and issued a well reasoned opinion. Accordingly, this Court need not grant certiorari.

II.

OTHER REASONS WHICH MILITATE AGAINST GRANTING CERTIORARI.

A. Congress has enacted new laws effectively eliminating the sale of a remainder interest transaction in estate planning.

In 1987, Congress enacted 26 U.S.C. § 2036(c) ("§ 2036(c)"), to be effective for decedents dying after December 31, 1987, but not applying to transfers completed before December 18, 1987. OBRA, '87, P.L. 100-203, 12/22/87. In 1990, Congress retroactively repealed § 2036(c) to the date of its enactment, and in its place enacted 26 U.S.C. §§ 2701, *et seq.* ("Chapter 14"). OBRA, '90, P.L. 101-508, 11/5/90. Neither § 2036(c), nor Chapter 14 apply to the Decedent's sale of her remainder interest in the Vaparo preferred stock because the sale was completed on September 1, 1987, prior to the effective dates of those statutes[9].

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9. As a result of the enactments of § 2036(c) and Chapter 14, practitioners would have been ill-advised to recommend a sale of remainder interest transaction after December 18, 1987. Accordingly, the issue in the instant case has limited application to transactions occurring at least nine or more years ago. Essentially, the issue has very little significance today.

Currently, Chapter 14 consists of special valuation rules which apply to sales of remainder interests, *inter alia*. Application of Chapter 14 results in current recognition and imposition of gift tax (instead of waiting until the transferor's death and including property in the transferor's gross estate for estate tax purposes). The Commissioner concedes that under Chapter 14 today, the Decedent's sale of her remainder interest in her Vaparo preferred stock would give rise to a current gift tax based upon the value of the retained life income interest, thereby making such a transaction wholly disadvantageous[10]. (Pet. at 21, n.13).

However, although footnote 13 of the Commissioner's Petition recognizes the enactment of § 2701, it fails to accurately represent the full breadth of Chapter 14 (which consists of §§ 2701, 2702, 2703 and 2704). In addition to § 2701's application to transfers involving interests in business entities, § 2702 addresses transfers into trusts and transfers like the one in the case at bar involving term interests[11], with respect to the

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10. The estate tax and gift tax systems are unified taxing systems whereby the same tax is imposed upon lifetime gifts as is imposed upon property includible in a decedent's gross estate. Of course, this is an overly simplistic explanation of a complex taxing system. However, as conceded by the Commissioner, if the Decedent's sale was subject to the provisions of Chapter 14 pursuant to § 2702(a)(2)(A), the Decedent's retained life income interest would be given a value of zero, thereby resulting in gift tax (in the year of the transaction) imposed upon the full value of the Vaparo preferred stock, less the consideration received. Accordingly, it would be taxed in the same manner and amount (except for the timing of the tax) as if the Vaparo preferred stock was includible in the Decedent's gross estate. (Pet. at 21, n.13). Under former § 2036(c), the sale of remainder interest transaction was effectively prevented by including the full value of the interest transferred in the Decedent's estate for estate tax purposes.

11. A term interest is one of a series of successive interests in property, for example, a life estate and remainder interest. Treas. Reg. § 25.2702-4(a).

transfer of all types of property. In an attempt to misguide this Court, the Commissioner inappropriately limits her discussion of the broad application of Chapter 14 to only § 2701. Although the Commissioner is correct in that "[m]ost transfers of property with retained life estates obviously fall outside the scope of [§ 2701]" (Pet. at 22, n.13). However, she fails to also point out that most transfers would not escape the provisions of § 2702 which addresses transfers of all types of property[12]. The Commissioner's obvious attempt to magnify the importance of the issue in the instant case, with the advent of Chapter 14 in mind, falls short of the mark.

Chapter 14 has effectively eliminated most transfers with retained interests (including the sale of a remainder interest) in estate planning. Only under certain very limited conditions will Chapter 14 not apply to a transfer with a retained interest. However, as a result of the enactment of Chapter 14, the Decedent's sale of her remainder interest in her Vaparo preferred stock would not be a recommended transfer today. Thus, the precedential value of granting certiorari here is dubious at best.

B. The issue in the instant case is not frequently litigated.

The Commissioner's Petition states that the issue in this case is frequently litigated. (Pet. at 11). However, the three cases cited to demonstrate a conflict among the circuits (*Gradow*, *Past* and *Allen*) were decided in 1990, 1965 and 1961 respectively[13]. (*supra*, n.7). Even assuming, arguendo, that those cases involved

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12. Chapter 14's focus is on transfers of property between family members. Nonfamilial transfers in the context of estate and gift tax planning is rather uncommon.

13. Other than *Gradow*, *Past* and *Allen*, *Gregory*, *supra*, (a Tax Court case) has been cited as precedence on the issue. *Gregory* was decided in 1963.

the same issue as in the instant case, it is a gross exaggeration to characterize three other circuit cases over a 26 year period as "frequently litigated." Furthermore, with the enactment of Chapter 14, the likelihood of this issue being litigated in the future is minimal. Accordingly, the infrequent and narrow implication of the issue here does not warrant certiorari to be granted by this Court.

C. The instant case was the first of its kind to reach a Federal circuit court, and accordingly, there is no conflict among the circuits.

The Decedent's sale of her remainder interest in her Vaparo preferred stock was properly structured, and all values were correctly computed using the prescribed Internal Revenue valuation tables. No other circuit court has decided the issue presented here regarding a properly structured sale of a remainder interest transaction. A review of *Allen*, *Past* and *Gradow* demonstrates that all three cases involved transactions that are factually distinct from the sale of a remainder interest presented in the instant case.

In *Allen*, the decedent gratuitously placed property in a trust retaining for herself a life estate in the property[14]. Years later, the decedent sold her retained life estate for an amount slightly

14. The use of a trust in *Allen*, *Past* and *Gradow*, creates a major distinction from the instant case. In those cases, the fee interest of the subject property was transferred into a trust, and the transferor reserved a life estate in the property transferred into the trust. Under those facts, clearly there has been a transfer of the full fee interest of the subject property into the trust, and under § 2036(a), consideration equal to the value of the transferred fee interest is required. In this case, the Decedent sold only the interest in the remainder of the Vaparo preferred stock, receiving consideration exactly equal to the value of the remainder interest. The Decedent never sold, transferred or otherwise disposed of the life income interest in the Vaparo preferred stock, in contrast to the transferors in *Allen*, *Past* and *Gradow*.

in excess of the fair market value of the retained life estate. In this case, the Decedent did not use a trust, but instead sold the remainder outright, keeping the life income interest. Further, in *Allen* the decedent sold the life estate whereas in this case the Decedent sold the remainder interest.

Past involved a divorce where, pursuant to a settlement, the community property of the decedent and her husband was transferred to a trust wherein the decedent received an income interest for life. The subject transfer in *Past* is the decedent's interest in her share of the community property into trust, in exchange for the life estate in the trust which also contained her husband's share. *Gradow* involved a surviving spouse election under her deceased husband's will to transfer her half of their community property to a trust (and her deceased husband's share would also be transferred to the trust) in exchange for the life estate in the trust. The inapposite facts of *Allen*, *Past* and *Gradow*, and the use of a trust in each of these cases (See *supra*, n.14), vitiate the Commissioner's attempt to demonstrate a conflict among the circuits.

The instant case is the only circuit court decision regarding the tax implication of a properly structured sale of a remainder interest under 26 U.S.C. § 2036(a). Thus, there is no conflict among the circuit courts regarding the issue involved here.

CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be denied.

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In the Supreme Court of the United States

OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF ROSE D'AMBROSIO, DECEASED,
VITA D'AMBROSIO, EXECUTRIX

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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TABLE OF AUTHORITIES

Case:	Page
Gradow v. *United States*, 897 F.2d 516 (Fed. Cir. 1990), aff'g 11 Cl. Ct. 808 (1987)	1
Statutes:	
Internal Revenue Code (26 U.S.C.):	
§ 2001(b)	5
§ 2012(a)	5
§ 2036	4, 6
§ 2036(a)	2, 3, 4, 6
§ 2036(a)(1)	4
§ 2043(a)	5
§ 2512(a)	5
§ 2701	3
§ 2702	3, 4, 5
§ 2702(a)	4
§ 2702(a)(2)(A)	4
§ 2702(b)(1)	4
Miscellaneous:	
J. Blattmachr & A. Painter, *Planning for Split-Interest Transfers Under the Section 2702 Final Regulations*, 240 PLI/Est 103 (1995)	5
M. Neumann, *Estate Freeze Techniques Outside of Chapter 14*, 2 NYU Proceedings of the Fifty-Third Institute on Federal Taxation (Matthew Bender 1995)	5
W. Scanlan, Jr., *GRITs, GRATs & GRUTs: A Phoenix Rises From the Ashes of Section 2036(c)*, The Twenty-Seventh Annual Philip E. Heckerling Institute On Estate Planning (Matthew Bender 1993)	6

Miscellaneous—Continued: Page

P. Schneider, *Section 2702 or GRITs, GRATs and GRUTs (What Does Your Client Want?)*, The Twenty-Sixth Annual Philip E. Heckerling Institute On Estate Planning (Matthew Bender 1992) 6

R. Stephens, S. Lind, G. Maxfield & D. Calfee, *Federal Estate and Gift Taxation* (7th ed. 1997) . 5

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1. The court of appeals candidly and correctly acknowledged that its interpretation of the controlling estate tax provisions squarely conflicts with the decision of the Federal Circuit in *Gradow* v. *United States*, 897 F.2d 516 (1990), aff'g 11 Cl. Ct. 808 (1987). See Pet. 7-10. The court explained that (Pet. App. 11a):

> [W]e cannot agree with the *Gradow* court's conclusions that "property" refers to the fee simple interest and that adequate consideration [for purposes of 26 U.S.C. 2036(a)] must be measured against that value.

Respondent errs in claiming that this conflict need not be resolved simply because the conflicting appellate decisions under Section 2036(a) "involved transactions that are factually distinct from the sale of a remainder interest presented in the instant case" (Br. in Opp. 14). As the court of appeals noted, the issue of statutory interpretation presented in this case occurs in numerous factual contexts, for "techniques for attempting to reduce estate taxes are limited only by the imagination of estate planners, and * * * new devices appear regularly" (Pet. App. 13a). The fact that the reported appellate decisions have addressed this legal issue in a variety of factual contexts emphasizes the broad and recurring importance of the question presented.

As the court acknowledged in this case, the circuits have disagreed as to the proper meaning and application of Section 2036(a). See Pet. 15-18; Pet. App. 11a. Professional advisors, on whom taxpayers necessarily rely in making estate planning decisions, have expressed the same uncertainty and disagreement. See Pet. App. 18a-19a & n.3; *id.* at 30a-31a ("Numerous articles have been written on this issue, and the legal commentators debate its resolution."). In the absence of review by this Court, and in the face of this continuing uncertainty, taxpayers will be unable to determine with reliability the consequences of the estate planning choices that they are to make. This is unfair to taxpayers, for errors in estate planning cannot be corrected after the taxpayer's death.

2. Respondent errs in asserting that resolution of this conflict among the circuits is unnecessary because the "issue in the instant case is not frequently litigated" (Br. in Opp. 13). As respondent concedes (*ibid.*), four of the courts of appeals have now

had occasion to address the question presented in this case. Moreover, as the petition notes, two additional cases presenting this same legal issue are presently pending in other circuits (Pet. 24). The fact that the Third Circuit, in the present case, has created a conflict among the circuits on the proper interpretation of Section 2036(a) will plainly increase even further the volume of such litigation. New estate planning devices "appear regularly" before the courts (Pet. App. 13a) precisely because of the recurring interest of taxpayers and estate planners in circumventing or limiting the effect of existing estate tax provisions.

3. Respondent also errs in claiming that review is unnecessary because "new laws" (Br. in Opp. 11) have eliminated the abuse that the decision in this case would permit.

a. The court of appeals erred in suggesting that 26 U.S.C. 2701, which was added to the Code in 1990, resolves future concern over "abusive transfers of remainder interests" (Pet. App. 14a n.2). As we explain in the petition, and as respondent acknowledges, that statute addresses only "transfers involving interests in business entities" (Br. in Opp. 12). It does not generally address abusive transfers of remainder interests of the type involved in this case. See Pet. 21-22 n.13.

b. Respondent nonetheless claims that 26 U.S.C. 2702—a provision *not* cited by the court of appeals—"addresses transfers of all types of property" (Br. in Opp. 13) and thereby diminishes the continuing importance of the issue presented in this case. That contention is not correct.

Section 2702 addresses only the application of the *gift* tax to transfers covered by that Section. The

rules established in Section 2702 are "*[s]olely* for purposes of determining whether a transfer * * * is a gift" and, if so, "the value of such transfer" (26 U.S.C. 2702(a) (emphasis added)). By contrast, the rules of Section 2036(a), which the present case involves, are solely for the purpose of determining "[t]he value of the gross estate" for purposes of the *estate* tax (26 U.S.C. 2036(a)). Whether or not a gift tax is imposed at the time of the transfer (under Section 2702), an estate tax will result at the time of death (under Section 2036(a)) if the transferor "retained for his life * * * the possession or enjoyment of, or the right to the income from, the property" (26 U.S.C. 2036(a)(1)). The rules of these two Sections of the Code supplement each other. They do not displace each other.*

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* As noted in the petition (Pet. 21-22 n.13), a transfer of a remainder interest to a family member, with a life estate retained by the transferor, would trigger an immediate gift tax for the amount by which the value of the property exceeds the value of any consideration received from the transfer. In calculating the amount of this imputed gift, Section 2702 establishes a prophylactic rule under which *no* value is attributed to the retained life estate unless it is in the form of a "qualified interest" (26 U.S.C. 2702(a)(2)(A)), a term that generally refers to a right to receive a fixed, periodic payment (26 U.S.C. 2702(b)(1)). If a gift tax were required under the prophylactic rule of Section 2702, that would not remove the transfer from the coverage of the estate tax under Section 2036. Similarly, if a gift tax were *not* paid (because the tranferor retained a "qualified interest"), that too would not remove the transfer from the coverage of the estate tax. Section 2702 does not repeal Section 2036. The Code specifically contemplates that transfers to which the gift tax has applied may be "pulled back" into the estate and subjected to the estate tax; double taxation is avoided by the credit available

As several commentators have noted, property in which the transferor retains a life estate is "included in the gross estate of the transferor [under Section 2036(a)], regardless of whether Section 2702 applied to the original transfer." R. Stephens, S. Lind, G. Maxfield & D. Calfee, *Federal Estate and Gift Taxation* ¶ 19.03[4][c], at 19-120 n.322 (7th ed. 1997). If the retained "life estate is not subsequently gifted and the transferor dies, the property generating the income interest would be pulled into the tranferor's gross estate under Section 2036." *Id.* at 19-119 to 19-120. See also J. Blattmachr & A. Painter, *Planning for Split-Interest Transfers Under the Section 2702 Final Regulations*, 240 PLI/Est 103, 108 n.20 (1995); note *, *supra*.

The enactment of Sections 2701 and 2702 has not lessened the interest of practitioners in devising means of avoiding the estate tax imposed under Section 2036. The professional literature burgeons with discussions addressing that objective. See,

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under the estate tax for any gift tax paid in connection with the transfer. 26 U.S.C. 2001(b); see 26 U.S.C. 2012(a).

Even in the limited situations in which a gift tax is applied to the transfer under Section 2702, the value of the taxable transfer is different under the gift and estate tax: the estate tax reaches the value of the property on the date of death (26 U.S.C. 2043(a)); the gift tax is instead calculated on the value of the gift on the date the gift is made (26 U.S.C. 2512(a)). The estate tax thus captures the accretion of value occurring after transfers of a testamentary nature are made in the guise of *inter vivos* dispositions of "remainder" interests in property. See M. Neumann, *Estate Freeze Techniques Outside of Chapter 14*, 2 NYU Proceedings of the Fifty-Third Institute on Federal Taxation ¶ 21.08[1][b], at 21-39 (Matthew Bender 1995) ("the Grantor's gross estate will include the entire fair market value of the property * * * as of the date of the Grantor's death").

e.g., W. Scanlan, Jr., *GRITs, GRATs & GRUTs: A Phoenix Rises From the Ashes of Section 2036(c)*, The Twenty-Seventh Annual Philip E. Heckerling Institute On Estate Planning ¶ 1409.3, at 14-29 (Matthew Bender 1993); P. Schneider, *Section 2702 or GRITs, GRATs and GRUTs (What Does Your Client Want?)*, The Twenty-Sixth Annual Philip E. Heckerling Institute On Estate Planning ¶ 1204.6, at 12-45 (Matthew Bender 1992). Respondent is thus simply incorrect in contending that "new laws" relating to the *gift* tax implications of *inter vivos* transfers of remainder interests have "effectively eliminated" (Br. in Opp. 13) the *estate* tax issues relating to such transfers under Section 2036. To the contrary, as the commentators cited above have noted, these "new laws" neither address nor resolve the recurring *estate* tax issues under Section 2036(a). See also note *, *supra*.

4. It is a common "Federal estate planning technique" to employ an *inter vivos* transfer of remainder interests in an effort "to remove the value of property from Decedent's gross estate" (Pet. App. 30a). Prior to the decision in this case, the courts had consistently held that such transfers are ineffective to accomplish that goal unless the decedent received, in return, property of equal value. By disagreeing with that uniform view, and by creating a conflict among the circuits on the proper interepretation of Section 2036, the decision in this case creates pervasive uncertainty for taxpayers and tax planners—and for the administration of the estate tax.

* * * * *

For the reasons stated above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

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